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IN THE

Supreme Court of the United States

OCTOBER TERM, 1984

WILLIAM Z. SALCER, *et al.*,
Petitioners,

v.

ENVICON EQUITIES CORP., *et al.*,
Respondents.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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March 13, 1985

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QUESTION PRESENTED FOR REVIEW

In an action for damages under the antifraud provisions of the federal securities laws, are defendants entitled to offset a damage award by the amount of tax benefits realized by plaintiff-investors?

PARTIES

Petitioners – plaintiffs-appellees below – are William Z. Salcer, Panfeld, Edelman, a Texas General Partnership, Robert L. Andrews, Sanjivani C. Bakare, H.E. Chiles, Ronald Salcer, Alonzo J. Drummond, George D. Gibson, Gerald I. Green, William L. Horner, Donald V. McClarty, Stanley W. Mandel, Renato Martinez, F.J. Mikulenka, Jr., J.B. Randle, Bernard J. Sackaroff, Robert L. Scheer, Jack P. Solovy, Swanson Analysts Systems, Inc. and Bruce L. Weinberg. Swanson Analysts Systems, Inc., has no parent companies, subsidiaries, or affiliates.

Respondents – defendants-appellants below – are Envicon Equities Corp., Envicon Development Corp., Envitex Realty Corp., Venture Development Group, Inc., U.S. Southwest Associates, U.S. Properties/Southwest, Turning Block Associates, Feit & Ahrens, William B. Bush, Jr., John W. Galston, Erving Wolf, Harry W. Burrow, and Blonder, Seymour & Shapss.

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No.

WILLIAM Z. SALCER, *et al.*,
Petitioners,

v.

ENVICON EQUITIES CORP., *et al.*,
Respondents.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Petitioners William Z. Salcer, *et al.*, respectfully petition this Court, pursuant to 28 U.S.C. § 1254(1) and Rule 19 of the Rules of this Court, for a writ of certiorari to the United States Court of Appeals for the Second Circuit in the case of *Salcer v. Envicon Equities*, 744 F.2d 935 (1984).

OPINIONS BELOW

The opinion of the court of appeals is reported at 744 F.2d 935 and is set forth in Appendix A. The unreported oral opinion of the district court granting the motion to strike certain affirmative defenses is set forth in Appendix E. The order of the district court dated February 2, 1984,

striking certain affirmative defenses is set forth in Appendix B. Excerpts from the transcript of oral argument before the district court on December 9, 1983, are set forth in Appendix F.

JURISDICTION

The judgment of the court of appeals reversing the district court was entered September 19, 1984. A timely petition for rehearing or rehearing *en banc* was denied on November 15, 1984, and is attached as Appendix D. On petitioners' timely motion filed February 1, 1985, this Court extended the time within which to file a petition for writ of certiorari to March 13, 1985. This Court has jurisdiction to review the decision of the court of appeals under 28 U.S.C. § 1254(1).

STATUTORY PROVISION

The following statute pertains to this case: section 28(a) of the Securities Exchange Act, 15 U.S.C. § 78bb(a), which is attached as Appendix C.

STATEMENT OF THE CASE

Petitioners are investors who purchased 15 partnership interests or units (out of 20) in Greenspoint Associates, a limited partnership that was established to build and operate a residential apartment complex called Greenspoint Project, located in Harris County, Texas, adjacent to Houston. Petitioners purchased their units between October 1977 and May 1978 at a cost per unit of $77,500. Respondents are the general partners and the accountant of Greenspoint Associates. The units were sold on the

basis of a private placement memorandum, dated October 19, 1977, and a supplemental financial analysis which included projections of tax losses, cash flow, and taxable income to be derived from the investment. Construction delays caused by the annexation by the City of Houston of the area in which Greenspoint Project is located and the consequent loss of a permanent mortgage loan commitment forced the sale of the project to an affiliate of the general partners in September 1981. Each petitioner received $30,000 per unit from the sale, resulting in a loss of $47,500. App. A, 3a-4a.

Petitioners brought suit in the Southern District of New York under section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and SEC rule 10b-5, 17 C.F.R. § 240.10b-5, seeking rescissionary damages for respondents' failure to disclose material information on the Greenspoint Project. Specifically, petitioners alleged that respondents knew or should have known, but failed to disclose to purchasers, that the City of Houston planned to annex the part of Harris County in which the Greenspoint Project was to be built; and that annexation would cause substantial increases in construction and operating costs and thereby jeopardize the permanent financing of the project. App. A, 1a, 4a.

Respondents asserted as an affirmative defense that the petitioners had each realized tax benefits from their Greenspoint investments exceeding $47,500, which respondents were entitled to offset against any damages awarded. Petitioners filed a motion under Fed. R. Civ. P. 12(c), (f), and 56 to strike the affirmative defense or grant partial summary judgment on the ground that the defense was insufficient as a matter of law. App. A, 5a.

Following oral argument, the district court granted the

motion to strike, *see* App. E, and issued an appropriate order. *See* App. B. The trial court certified the question as appropriate for interlocutory review under 28 U.S.C. § 1292(b), and respondents appealed. App. A, 6a. The Securities Exchange Commission and the Tax Division of the Department of Justice filed briefs *amici curiae* in support of petitioners.

On appeal, the United States Court of Appeals for the Second Circuit reversed. The court first pointed out that damages under the Securities Exchange Act of 1934 are governed by section 28(a), 15 U.S.C. § 78bb(a), which limits damages to "actual damages of the act complained of." *See* App. C, 23a. The court conceptually divided petitioners' investment into two components: an investment in part to realize tax benefits and in part to attain appreciation and income. Because petitioners admittedly received tax benefits, the court held that respondents' fraud injured only the appreciation and income component of the investment. Thus, to calculate "actual damages" under the 1934 Act, "all benefits [petitioners] received from their investment, including tax benefits, would have to be deducted in calculating the rescissionary damages. . . ." App. A, 11a.

The court rejected arguments advanced by the SEC that tax benefits should not be deducted from defendants' damages. The SEC argued that such a rule: a) undermines the incentive for "private attorneys general" to enforce the federal securities laws; and b) renders the "government the banker for fraudulent tax shelter activity," *citing Burgess v. Premier Corp.*, 727 F.2d 826, 838 (9th Cir. 1984). *See* App. A, 11a-12a. The court also rejected the contention put forth by the Tax Division that tax benefits realized by petitioners may be "illusory"; that the IRS may in fact

disallow them; and that, accordingly, they should be disregarded. App. A, 14a-15a.

The Second Circuit thus concluded that the motion to strike should not have been granted[1] and remanded the case. Petitioners filed a timely motion for rehearing or rehearing *en banc,* which the court denied. App. D.

REASONS FOR GRANTING THE WRIT

INTRODUCTION

This case squarely presents an issue that has never been decided by this Court: the effect of tax benefits on the measure of damages in a suit brought under section 10(b) of the Securities Exchange Act of 1934 and rule 10b-5. Resolution is important because the issue may arise in virtually all federal securities litigation[2], and it is necessary because the Circuits are hopelessly divided.[3]

The decision by the court below is wrong. Neither the language, intent, or purpose of the Securities Exchange Act, nor its legislative history supports the decision. Considerations of public policy also favor a different rule. Under the Second Circuit's decision, damages resulting from the fraudulent sale of securities are mitigated to the extent there is a tax benefit, and the burden is borne by the federal government and the investors. The decision will inevitably encourage securities fraud in the sale of tax sheltered investments and deprive the federal government of taxes that it would otherwise receive from investors upon their receipt of damages from fraudfeasors.

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[1] *See* pp. 6-7, *infra.*

[2] The issue will also arise in private suits brought under the Commodity Exchange Act. *See Merrill Lynch, Pierce, Fenner & Smith v. Curran,* 456 U.S. 353 (1982)

[3] *See* pp. 13-14, *infra.*

The Second Circuit decision will require the courts, juries, and parties in virtually every securities fraud case to engage in a prior evaluation of the tax returns of plaintiffs, violate the confidentiality of tax returns, and speculate upon the tax treatment to be accorded to plaintiffs by the IRS. The court below should have applied the "collateral source" rule which traditionally has been applied to the assessment of damages in tort and fraud cases. Under this rule, benefits received by plaintiffs from third parties are not credited against the defendant's liability.

ARGUMENT

Before addressing the merits of this case, the court of appeals' contention that the trial court improperly used the motion to strike under Fed. R. Civ. P. 12(f) must be considered. The appellate court applied the rule that motions to strike are not favored and held that in this case "there exist material issues that can only be resolved after the facts are known." App. A, 18a. It is true that motions to strike are not generally favored. *See* 5 C. Wright & A. Miller, *Federal Practice & Procedure* § 1381 (1969). It is equally true, however, that under the Federal Rules of Civil Procedure how a motion is labeled or characterized by the moving party is of "little importance" in determining how a court treats the motion. *Id.* § 1380. The Second Circuit, among other courts, has approved treating a motion to strike as a motion for summary judgment if accompanied by supporting documents. *Ciprari v. Servicos Aereos Cruzeiro,* 245 F. Supp. 819, 820 (1965), *aff'd,* 359 F.2d 855 (1966). Moreover, petitioners filed their motion under rule 56, as well as rule 12(f). App. A, 5a.

The facts relevant to petitioners' motion to strike are not in dispute. The trial court accepted stipulations of counsel

based on documents submitted by respondents as the factual basis or record upon which to adjudicate the motion. *See* App. F, 33a-35a. Stipulations of counsel, like admissions, are binding on the party offering them and may properly provide the factual predicate for a motion for summary judgment. Fed. R. Civ. P. 56(c); *see, e.g., Glick v. White Motor Co.*, 458 F.2d 1287, 1291 (3d Cir. 1972); *Haberman v. Murchison*, 468 F.2d 1305, 1315 (2d Cir. 1972); *In re Georgia Jewelers, Inc.*, 219 F. Supp. 386, 391 (N.D. Ga. 1962). Thus, the trial court made it clear that with the stipulations of counsel, he was treating the motion to strike as one for summary judgment. "[F]orget about whether it's for a motion to strike affirmative defenses or not. . . . There is a pure question of law with that underpinning of facts, and it's just like a motion for summary judgment addressed to an affirmative defense." App. F, 36a.

In short, the "facts" that the court of appeals believes need to be "resolved," App. A, 18a, are material only because the court rejected the trial court's legal holding concerning the tax benefit offset rule. Had the court of appeals accepted the trial court's legal conclusion – the issue now before this Court – it could have no objection to the procedure followed by the trial court.

In addressing whether tax benefits must be taken into account in assessing damages under the Securities Exchange Act of 1934,[4] "the starting point," as this Court

[4]Resolution of the tax offset question presented by this case in the context of the 1934 Act would apply as well to the Securities Act of 1933. Although the 1933 Act has no provision comparable to section 28 of the 1934 Act, the courts measure damages under both Acts in similar fashion. *See generally*, III L. Loss, *Securities Regulation* 1721 (2d ed. 1961).

has enjoined, "is the language [of the statute] itself." *Ernst & Ernst v. Hochfelder,* 425 U.S. 185, 197 (1976). Section 28(a) provides in relevant part:

> The rights and remedies provided by this chapter shall be in addition to any and all other rights and remedies that may exist at law or in equity; but no person permitted to maintain a suit for damages under the provisions of this chapter shall recover, through satisfaction of judgment in one or more actions, a total amount in excess of his actual damages on account of the act complained of . . . .

15 U.S.C. § 78bb(a); *see* App. C, 23a. From the phrase "actual damages," the court of appeals concluded that tax benefits received by a plaintiff must be deducted from any judgment because they represent "real economic value mitigating any loss. . . ." App. A, 9a.

This contention, however, begs the question of what the 1934 Act intended by the description "actual damages." The structure of section 28(a) suggests that the limitation of damages to "actual damages" is to prevent duplicative recovery by plaintiffs asserting claims in different forums and to exclude speculative damages from any recovery.

The first sentence of section 28(a) provides that the rights and remedies provided by the Securities Exchange Act are "in addition to any and all other rights and remedies that may exist at law or in equity." The purpose of this sentence is to make clear that federal remedies do not pre-empt remedies that may exist under state laws. The phrase "actual damages," which immediately follows in section 28(a), is thus designed to prevent a plaintiff from recovering more than once for the same violation or cause of action. *E.g., Osofsky v. Zipf,* 645 F.2d 107, 111 (2d

Cir. 1981). The Act's legislative history provides no additional insight into the legislative intent.

Under these circumstances, the courts have relied on "practical factors" and "policy considerations" to explicate the intent of Congress. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 749 (1975). All practical and policy considerations favor excluding tax benefits in the calculation of damages.

Underlying the court's decision is the unarticulated assumption that the tax benefits received by a plaintiff-investor are attributable to the defendant, which must be accounted for when damages are calculated. This assumption is false. Tax benefits are granted by the government, not the developer; the level of these benefits is determined by the plaintiff-investor's tax situation, not that of the developer. *See Hayden v. McDonald,* 742 F.2d 423, 442 (8th Cir. 1984) (Lay, J., concurring). Moreover, the receipt of tax benefits is not related in any way to any act of the developer.[5] By crediting to the defendant benefits conferred by the government, the court of appeals' rule effectively brings about a transfer of funds from the government to the defendant. In the colorful phrase of the Ninth Circuit, the "government [becomes] the banker for fraudulent tax shelter activity." *Burgess v. Premier Corp., supra*, 727 F.2d at 838.

Three harmful effects follow from the court of appeals' decision in this case. First, in all securities fraud cases, the

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[5]The court of appeals correctly observed that "the investor normally pays a higher price for a tax shelter than for one involving simply future growth or income." App. A, 10a. What the court failed to point out is that the incremental cost of a tax shelter investment over one offering no tax shelter simply increases the promoter's profits.

rule will reduce a defendant's damages. In many instances – particularly where as in the case at bar the investment is induced and promoted by tax laws designed to further socially desirable goals – the court's rule may eliminate damages altogether. The policies of encouraging certain types of investments and discouraging securities fraud are not served when those who commit fraud escape sanctions.

The decision in this case would do violence to the rule prohibiting fiduciaries from profiting from transactions with their beneficiaries. By hypothesis, the general partners in this case committed fraud. Yet the decision below would allow them to escape responsibility and reap the tax benefits intended by Congress to benefit those who risk their capital in investments deemed socially useful. As this Court observed in *Superintendent of Insurance v. Bankers Life & Casualty Co.*, the Congress "made clear that 'disregard of trust relationships by those whom the law should regard as fiduciaries, are all a single seamless web' along with manipulation, investor's ignorance, and the like." 404 U.S. 6, 10-11 (1971) (quoting H.R. Rep. No. 1383, 73d Cong., 2d Sess. 6).

The second effect of the decision below is to reduce government revenue and to bring the government into the fraudulent transaction to assist those committing the fraud. *See Western Federal Corp. v. Davis,* 553 F. Supp. 818, 821 (D. Ariz. 1982), *aff'd sub nom. Western Federal Corp. v. Erickson,* 739 F.2d 1439 (9th Cir. 1984). The court's analysis accounts for only a portion of the tax consequences of the transaction: the tax benefits that the plaintiff received. In fact, a complete account of those consequences must include not only the tax benefits received by the plaintiff, but the government's later capture, as

ordinary income, of a portion of the damages received by plaintiffs. 1 J. Mertens, *Law of Federal Income Taxation,* § 7.34.

Third, the rule adopted by the Second Circuit will cause serious adjudicatory problems. If tax benefits are a factor in the award of damages, plaintiffs will have to submit their otherwise confidential tax returns to the scrutiny of other parties, the court, and jury. *See* 26 U.S.C. § 6103(a) (prohibiting unauthorized disclosure of tax returns or tax return information); 26 U.S.C. § 7431 (civil damage remedy for unauthorized disclosure of tax returns or tax return information).

Even when a litigant's income is legitimately at issue, the courts are reluctant to allow the discovery of tax returns. *E.g., Payne v. Howard,* 75 F.R.D. 465, 469-70 (D.D.C. 1977) ("policy against disclosure applies with equal force to protect tax returns in the hands of private litigants"). When the litigant's taxable income is merely a collateral issue — as it surely is in a federal securities case — the confidentiality policy would be seriously compromised if a defendant could routinely discover the plaintiff's tax returns.

Even worse than discovery by the defendant, a plaintiff would have to contemplate that in a trial to recover damages for securities fraud his tax filings may become public. A defendant might challenge a plaintiff's return in order to lower his damages, thus defeating the purpose of any protective order restricting access that a court might otherwise grant during discovery. Indeed, at least one court has expressly decided that the court and jury may examine the plaintiff's tax returns when adjudicating damages under section 10(b) of the 1934 Act. *Austin v.*

Loftsgaarden, 675 F.2d 168, 183 (8th Cir. 1982), *en banc reconsideration granted*, Oct. 17, 1984.

Subjecting tax returns to the scrutiny of litigants is thoroughly inappropriate in securities cases, defeats the purposes that the confidentiality provisions of the Internal Revenue Code are designed to promote, and will discourage parties from seeking relief from fraud under the federal securities acts. Moreover, it is doubtful that there can be any recovery at all until tax issues, including those unrelated to the securities fraud, are resolved. It is impossible to determine the tax bracket of a plaintiff until his return has been finally accepted. The court's rule would, contrary to public policy, tend to keep litigation open and reduce the certainty of the law.

The Second Circuit rule would also create anomalous damage awards. Plaintiffs in different tax brackets, but in all other respects identically situated with respect to the investment at issue, would receive different damages. Disparate treatment of investors based upon their taxable income undermines the purposes of the federal securities laws. *See Herman & MacLean v. Huddleston,* 459 U.S. 375, 390 (1983).

The issue presented in this case in the context of the federal securities laws commonly arises in tort cases: whether insurance benefits or other payments received by a plaintiff should reduce an award of damages. Through invocation of the so-called "collateral source" rule, courts almost universally have adopted a rule contrary to the rule chosen by the court of appeals in this case. *E.g., Hall v. Chicago & North Western Ry.,* 5 Ill.2d 135, 151, 125 N.E.2d 77, 86 (1955).

As set forth in the Restatement (Second) of Torts § 920A(2):

> Payments made to or benefits conferred on the injured party from other sources are not credited against the tortfeasor's liability, although they cover all or a part of the harm for which the tortfeasor is liable.

The commentary states that a "benefit that is directed to the injured party should not be shifted so as to become a windfall for the tortfeasor. . . . If the benefit was a gift to the plaintiff from a third party or established for him by law, he should not be deprived of the advantage that it confers." *Id.* Comment b. The tax benefits received by petitioners are comparable to benefits subject to the collateral source rule. They are received from a third party or established by law. The policies that support the exclusion of collateral sources in the tort area apply *a fortiori* when the tort involves, as in this case, intentional fraud.

The importance of resolving the issue presented – because it arises in virtually every securities fraud case – is clear.[6] In addition, however, the Circuits are at odds on the question. Joining the Second Circuit is the Fifth Circuit. *Bridgen v. Scott,* 456 F. Supp. 1048, 1061 (S.D. Tex. 1978); *see Dupuy v. Dupuy,* 551 F.2d 1005, 1024-25 (5th

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[6]The court below emphasized both the importance of the question presented by this case and the disagreement among courts of its proper resolution.

> The legal issue on the present appeal is substantial and disputed. We have never addressed the question of whether, in an action alleging fraud with respect to a tax shelter investment, the plaintiff's recovery must be reduced by tax benefits received. Those courts considering the question have reached differing conclusions. Thus the law on this point is confused and unsettled.

App. A, 8a (citations omitted). The involvement of two government agencies, the SEC and the Tax Division of the Justice Department, in the proceedings below highlights the public importance of this issue.

Cir. 1977). The Seventh and Ninth Circuits, by contrast, have adopted the rule that damages should not be reduced by the tax benefits received by a plaintiff. *Spatz v. Borenstein,* 513 F. Supp. 571, 586 (N.D. Ill. 1981); *Burgess v. Premier Corp., supra; Western Federal Corp. v. Erickson,* 739 F.2d 1439, 1444 (9th Cir. 1984). The Eighth Circuit is itself divided. *Compare Hayden v. McDonald, supra* (damages not reduced by tax benefits), *with Austin v. Loftsgaarden, supra* (damages reduced by tax benefits), *en banc reconsideration granted,* Oct. 17, 1984.[7] However the Eighth Circuit resolves the issue *en banc,* the division among the Circuits will remain. This Court should resolve the conflict and review the decision below.

[7]Both the SEC and the Tax Division of the Department of Justice have filed briefs *amici curiae* in *Austin*, requesting the Eighth Circuit to overrule the panel decision.

CONCLUSION

For the reasons stated, this Court should grant the writ of certiorari to the United States Court of Appeals for the Second Circuit.

Respectfully submitted,

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March 13, 1985

APPENDIX A

WILLIAM Z. SALCER, PANFELD, EDELMAN, et al., a Texas General Partnership, Robert L. Andrews, M.D., Sanjivani C. Bakare, M.D., H.E. Chiles, Ronald Salcer, Alonzo J. Drummond, M.D., George D. Gibson, Gerald I. Green, M.D., William L. Horner, Donald V. McClarty, Stanley W. Mandel, Renato Martinez, M.D., F.J. Mikulenka, Jr., J.B. Randle, Bernard J. Sackaroff, Robert L. Scheer, Jack P. Solovy, Swanson Analysts Systems, Inc. and Bruce L. Weinberger, M.D., Plaintiffs-Appellees.

v.

ENVICON EQUITIES CORP., Envicon Development Corp., Envitex Realty Corp., Venture Development Group Inc., a Texas Corporation, U.S. Southwest Associates, a Texas General Partnership, U.S. Properties/Southwest, a Texas General Partnership, Turning Block Associates, a New York Limited Partnership, Feit & Ahrens, a New York Partnership, William B. Bush, Jr., John W. Galston, Erving Wolf, Harry W. Burrow and Blonder, Seymour & Shapss, a New York Partnership, Defendants-Appellants.

Nos. 1340, 1455-1458, Dockets 84-7183, 84-7185, 84-7187, 84-7189, 84-7191.

United States Court of Appeals,
Second Circuit.

Argued June 18, 1984.

Decided Sept. 19, 1984.

Before MANSFIELD, MESKILL and CARDAMONE, Circuit Judges.

MANSFIELD, Circuit Judge:

In this action in the Southern District of New York under § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78j(b),[1] and S.E.C. Rule 10(b)5, 17 C.F.R. § 240.10b-5,[2] plaintiffs seek rescissionary damages for defendants' alleged failure to disclose material information relating to a real estate tax shelter in which the plaintiffs invested. Having been granted an interlocutory ap-

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[1] "§ 78j. Manipulative and deceptive devices

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

* * * * * *

"(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

[2] "§ 240.10b-5. Employment of manipulative and deceptive devices.

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

"(a) To employ any device, scheme or artifice to defraud,

"(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

"(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."

peal pursuant to 28 U.S.C. § 1292(b),[3] defendants challenge the order of Judge Vincent L. Broderick granting plaintiffs' motion to strike defendants' affirmative defense to the effect that any damages must be reduced by the amount of tax benefits admittedly realized by the plaintiffs. Judge Broderick ruled that the defense was inadequate as a matter of law. We reverse.

Plaintiffs are purchasers of 15 partnership interests ("units") in Greenspoint Associates, a limited partnership established to construct, own and operate a residential apartment complex known as "the Greenspoint Project." Defendants are the general partners of Greenspoint Associates and their affiliates, accountants, and attorneys. Plaintiffs purchased their units for $77,500 each between October 1, 1977 and April 30, 1978, based in part on sales literature including an October 1979 Private Placement Memorandum and projections included in a financial analysis dated October 19, 1977. The literature indicated that Greenspoint Associates was a Texas limited partnership and that the Greenspoint Project was to be a 308-unit multi-family rental complex located in Harris County, Texas, outside of the Houston city limits. Although the Private Placement Memorandum is not part of the record, portions of it were annexed to an affidavit in opposition to plaintiffs' motion to strike. The memorandum stated:

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[3] "(b) When a district judge, in making in a civil action an order not otherwise appealable under this section, shall be of the opinion that such order involves a controlling question of law as to which there is substantial ground for difference of opinion and that an immediate appeal from the order may materially advance the ultimate termination of the litigation, he shall so state in writing in such order. The Court of Appeals may thereupon, in its discretion, permit an appeal to be taken from such order. . . ."

> "[I]nvestment in the Units is suitable only for persons of adequate financial means who have no need for liquidity with respect to their investment. Only persons whose income is subject to high rates of income taxation will derive the full economic benefit of the intended tax benefits of this offering."

Plaintiffs alleged in the first count of their Amended Complaint that defendants knew or should have known, and failed to disclose, that the City of Houston was planning to annex that part of Harris County in which the Greenspoint Project was to be built. According to plaintiffs, annexation could be expected to cause a marked increase in the costs of building and operating the project because of (1) the imposition of water, sewer and building permits, certificates of occupancy, sales tax and real estate taxes, (2) additional construction requirements such as water and sewer utility lines, landscaping and sidewalks, (3) additional roofing, plumbing and electrical work needed to comply with Houston's building code, and (4) a delay in the project's completion that would jeopardize the permanent financing described in the sales literature. The City of Houston did annex the area and a forced sale of the premises occurred in September 1981. Each plaintiff received $30,000 per unit as a result of the forced sale and claims a net investment loss of $47,500 per unit. Since the forced sale rendered rescission impossible, plaintiffs seek the latter amount per unit as rescissionary damages.

Each defendant included in the answer to the complaint an affirmative defense, asserting that plaintiffs had realized tax benefits stemming from their investment that were in excess of their claimed loss of $47,500. The defenses were premised on the assumption that each plaintiff was taxed at a marginal rate of at least 50% during the years

1977 through 1981, an assumption that plaintiffs do not challenge. There has not, however, been any discovery of the actual tax consequences for each plaintiff.

On August 29, 1983, plaintiffs moved for an order pursuant to Fed.R.Civ.P. 12(c), 12(f), and/or 56, to strike these affirmative defenses. Oral argument on the motion was held on December 9, 1983, at which time the parties stipulated that tax benefits were a factor in plaintiffs' decision to purchase their units and that defendants' calculations showing tax benefits to each plaintiff exceeding the $47,500 were correct. Defendants sought discovery for the purpose of proving that "with one or more plaintiffs the sole reason they got into this investment was because of the tax benefits." The district court agreed that "a desire for very extensive tax deductions was a primary motivation for people to invest here, because the whole thrust of the offering letter or the document was to that effect." However, Judge Broderick granted the Rule 12(f) motion to strike at the close of oral argument.

The district court reasoned that although "tax considerations come into this case in determining whether there was in fact a fraud committed," there were effectively two investments at issue: "One was the opportunity to receive currently available but probably rapidly wasting tax benefits or tax deductions or tax shelters. The second part of the bargain was an investment in a capital resource that ultimately they, the [plaintiffs], expected to increase in value" and to "ultimately produce income." The allegations of fraud, said the court, pertained only to the latter aspect of the investment; there had been no claim of fraud with respect to the tax consequences of the Greenspoint Project. The district court then concluded that it "makes no sense to say that any loss to the defrauded investor and

hence, any gain or recovery which he is entitled to should be reduced by the tax benefits that he has realized," stating:

> "Those tax benefits would have been realized whether or not there was a fraud in this particular situation.
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> * * * * * *
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> "The investor who was interested in tax considerations when he invested here could very well have invested in some entirely different company, realized comparable tax benefits, and not suffered the loss that the investors here are alleged to have suffered because of the fraud."

Judge Broderick stressed that the defendants would still be permitted to explore plaintiffs' tax shelter considerations in order to show that these were their prime motivations and that they did not rely on the defendants' alleged fraudulent omissions with respect to annexation of the site by the City of Houston. Since the issue of whether any recovery must be reduced by the amount of tax benefits was critical, plaintiffs having represented that if they received an adverse ruling on that issue they would drop their suit, the district court certified the issue as appropriate for interlocutory review under 28 U.S.C. § 1292(b).

DISCUSSION

A motion to strike an affirmative defense under Rule 12(f), Fed.R.Civ.P. for legal insufficiency is not favored and will not be granted "unless it appears to a certainty that plaintiffs would succeed despite any state of the facts which could be proved in support of the defense." *Durham*

Industries, Inc. v. North River Insurance Co., 482 F.Supp. 910, 913 (S.D.N.Y.1979) (quoting *Lehmann Trading Corp. v. J. & H. Stolow, Inc.*, 184 F.Supp. 21, 23-23 (S.D.N.Y.1960)). *See Mohegan Tribe v. State of Connecticut*, 528 F.Supp. 1359, 1362 (D.Conn.1982); *Meinrath v. Singer Co.*, 87 F.R.D. 422, 429 (S.D.N.Y.1980); *Wellman v. Dickinson*, 79 F.R.D. 341, 349 (S.D.N.Y.1978); *Sample v. Gotham Football Club, Inc.*, 59 F.R.D. 160, 168 (S.D.N.Y.1973); *Carter-Wallace, Inc. v. Riverton Laboratories, Inc.*, 47 F.R.D. 366, 367 (S.D.N.Y.1969). Moreover, even when the facts are not disputed, several courts have noted that a "motion to strike for insufficiency was never intended to furnish an opportunity for the determination of disputed and substantial questions of law." *Carter-Wallace, Inc. v. Riverton Laboratories, Inc., supra*, 47 F.R.D. at 367-68 (quoting *Budget Dress Corp. v. International Ladies' Garment Workers' Union*, 25 F.R.D. 506, 508 (S.D.N.Y. (1959)); *see also Augustus v. Board of Public Instruction*, 306 F.2d 862, 868 (5th Cir.1962); *Mohegan Tribe v. State of Connecticut, supra*, 528 F.Supp. at 1362; *Wellman v. Dickinson, supra*, 79 F.R.D. at 349; *Systems Corp. v. American Telephone & Telegraph Co.*, 60 F.R.D. 692, 694 (S.D.N.Y.1973). This is particularly so when, as here, there has been no significant discovery.

"[E]ven when the defense presents a purely legal question, the courts are very reluctant to determine disputed or substantial issues of law on a motion to strike; these questions quite properly are viewed as determinable only after discovery and a hearing on the merits." 5 C. Wright & A. Miller, *Federal Practice & Procedure* § 1381, at 800-01 (footnotes omitted). To do otherwise would be to run the risk of offering an advisory opinion on an abstract and hypothetical set of facts. *See Lunsford v. United States*,

570 F.2d 221, 229-30 (8th Cir.1977). *Accord Green Mountain Power Corp. v. General Electric Corp.*, 496 F.Supp. 169, 171 (D.Vt.1980); *S.E.C. v. Gulf & Western Industries*, 502 F.Supp. 343, 347 (D.D.C.1980); *Sample v. Gotham Football Club, supra*, 59 F.R.D. at 169; *Wellman v. Dickinson, supra*, 79 F.R.D. at 351.

The legal issue on the present appeal is substantial and disputed. We have never addressed the question of whether, in an action alleging fraud with respect to a tax shelter investment, the plaintiff's recovery must be reduced by tax benefits received. Those courts considering the question have reached differing conclusions. *Compare Burgess v. Premier Corp.*, 727 F.2d 826, 837-38 (9th Cir.1984) (not requiring reduction) *with Austin v. Loftsgaarden*, 675 F.2d 168, 180-84 (8th Cir.1982) (requiring deduction). Thus the law on this point is confused and unsettled. For reasons set out below, further facts must be obtained before the issue can definitively be resolved in this case. It was therefore error to strike the affirmative defenses.

In deciding what damages may be recovered for fraud in violation of the Securities Exchange Act we are governed by § 28(a), 15 U.S.C. § *78bb(a)*,[4] which limits damages in a civil suit based on violation of the Act to "ac-

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[4] "(a) The rights and remedies provided by this chapter shall be in addition to any and all other rights and remedies that may exist at law or in equity; but no person permitted to maintain a suit for damages under the provisions of this chapter shall recover, through satisfaction of judgment in one or more actions, a total amount in excess of his actual damages on account of the act complained of . . . ."

tual damages on account of the act complained of." As we stated in *Osofsky v. Zipf,* 645 F.2d 107, 111 (2d Cir.1981):

> "[T]he purpose of section 28(a) is to compensate civil plaintiffs for economic loss suffered as a result of wrongs committed in violation of the 1934 Act, whether the measure of those compensatory damages be out-of-pocket loss, the benefit of the bargain, or some other appropriate standard."

"Actual damages," as used in the Exchange Act, means "compensatory damages," *id.,* and hence a plaintiff cannot recover more than his or her "net economic loss." *Marbury Management, Inc. v. Kohn,* 470 F.Supp. 509, 516 (S.D.N.Y.1979), *aff'd in part, rev'd in part,* 629 F.2d 705 (2d Cir.), *cert. denied,* 449 U.S. 1011, 101 S.Ct. 566, 66 L.Ed.2d 469 (1980). It is not within our power to ignore benefits bargained for and received by plaintiffs as a result of the transaction at issue, which represent real economic value mitigating any loss they may have suffered.

One of the prime motivations for investment in limited real estate partnerships is the unique tax advantage made available to high tax bracket individuals. The partnership as an entity is not subject to taxation. It serves as a conduit through which partnership losses are passed on to the partners, thus providing a shelter to offset the investor's other taxable income to the extent of the adjusted basis of the investor's interest in the partnership. *See Austin v. Loftsgaarden, supra,* 675 F.2d at 173; Note, *Real Estate Limited Partnerships and Allocational Efficiency: The Incentive to Sue for Securities Fraud,* 63 Va.L. Rev. 669, 673 (1977). Indeed, in some such partnerships the investor's potential deductible losses may be increased, at least for a few years, to a point equalling the partner's original invest-

ment through use of accelerated depreciation methods, prepayment of mortgage interest, legal and accounting fees, commitment fees incurred in obtaining financing to buy the mortgage property, and the like, with taxation on any gain deferred until the investment is liquidated. *Id.* at 672-75. Even assuming that the investor's ultimate goal is to realize a gain from an income-producing business (either through sale or income), the intervening tax benefits to the partner represent an important tangible economic advantage expected to be derived from his investment regardless whether the venture eventually operates at a profit. The importance of this aspect of the investment is recognized in decisions awarding damages for failure of the tax advantages of shelters to live up to the seller's representations. *See, e.g., Sharp v. Coopers & Lybrand,* 649 F.2d 175 (3d Cir.1981) (holding accounting firm liable for acts of employee in preparing tax opinion letter), *cert. denied,* 455 U.S. 938, 102 S.Ct. 1427, 71 L.Ed.2d 648 (1982). In short, the investor normally pays a higher price for a tax shelter investment than for one involving simply future growth or income. *See* 4 R. Haft & P. Fass, *Tax Sheltered Investments,* Intro-8 to 9 (3d ed. 1981).

In the present case the district court took the view that at least a portion of plaintiffs' investment was made to realize tax benefits and the balance with a view to an income or appreciation potential.[5] Even given this theory,

[5]Upon appeal the SEC as amicus curiae takes the same view, stating (1) that "There is no claim in this case that the fraud undermined the legitimacy of the tax shelter treatment," SEC Brief 4, note 3, (2) that normally the purchase price includes "a premium representing the opportunity to obtain future tax benefits," *id.* 8, and (3) that "since the allegations of fraud relate only to the investment aspects of the project and there is no claim that the fraud affected the price paid for the tax shelter feature, the defendants would be liable in out-of-pocket damages only for the investment loss and would retain the initial premium paid for the right to future tax benefits," *id.,* 9.

the $77,500 investment in each unit, to the extent that it was paid for the opportunity to secure tax benefits, would not be rescindable since plaintiffs realized all of the tax benefits for which they bargained. Thus, using the district court's theory, it was error to grant the motion to strike without first making a factual determination of the allocation of the purchase price between the tax and appreciation components. To the extent that plaintiffs invested in a tax shelter, all benefits they received from their investment, including tax benefits, would have to be deducted in calculating the rescissionary damages, if any, to which they would be entitled.

Plaintiffs, joined by the Securities and Exchange Commission appearing as *amicus curiae,* argue that the district court's striking of the defense was proper because by refusing to "give the defendants credit" for tax benefits received by the plaintiffs it created an additional incentive for "private attorneys general" to file civil suits based on the securities laws. Regardless of the accuracy of that assumption, it is not for us but for Congess to create such incentives, *see, e.g., Alyeska Pipeline Service Co. v. Wilderness Society,* 421 U.S. 240, 263, 95 S.Ct. 1612, 1624, 44 L.Ed.2d 111 (1975) (shifting of attorneys fees by court to create incentive is impermissible), and Congress has demonstrated that it knows how to deter and punish securities fraud by enacting a series of laws authorizing proceedings without proof of actual damage required by Rule 10b-5, e.g., proceedings by the SEC and IRS, either in court or by administrative action, to enjoin fraudulent conduct or obtain disgorgement; criminal prosecutions and actions for civil fines. *Cf. Blue Chip Stamps v. Manor Drug Stores,* 421 U.S. 723, 95 S.Ct. 1917, 44 L.Ed.2d 539 (1975). We are barred from engaging in judicial legislation

by § 28(a) of the Exchange Act, which limits plaintiffs to recovery of their actual net economic loss and does not give us discretionary power to increase that amount in order to encourage the filing of private damage actions. In applying § 28(a) we cannot ignore the substantial economic tax benefits bargained for and realized by plaintiffs.

Nor can we agree with the notion that our ruling makes "the government the banker for fraudulent tax shelter activity," *Burgess v. Premier Corp., supra,* 727 F.2d at 838. As Judge Broderick noted, there was no such activity in this case; the fraud, if any, pertained only to the investment aspects of the Greenspoint Project. The government got the residential development that it hoped to encourage by offering the tax benefits taken by the plaintiffs. Thus, it is "banking" precisely what it agreed to "bank." There is no suggestion that the project did not meet federal requirements as a viable housing development entitling its owners to tax benefits.

For the same reasons plaintiffs' argument that defendants are not entitled to "credit" for the tax benefits because the latter were "provided" by the government rather than by the defendants must be rejected. The standard established by § 28(a) for determining the amount of damages to be awarded is not the egregiousness of the defendants' conduct but the extent of plaintiffs' actual injury. To ignore the sizeable tax benefits actually realized by the plaintiffs would be unrealistic. There is nothing improper or unusual in taking tax considerations into account in determining the amount of damages to be awarded. *See Norfolk & Western Railway Co. v. Liepelt,* 444 U.S. 490, 100 S.Ct. 755, 62 L.Ed.2d 689 (1980); *O'Connor v. United States,* 269 F.2d 578 (2d Cir.1959).

In an effort to avoid being credited with their realized tax benefits resulting from their investment in the tax shelter plaintiffs, joined by the S.E.C., argue that the tax benefits here should fall within the "collateral source" rule, which prohibits taking into consideration benefits received from third parties as the result of wholly separate and distinct transactions, such as those received under insurance policies negotiated independently. Restatement (Second) of Torts § 920A(2) (1979). A classic example is the court's ruling in a personal injury action that a plaintiff's recovery is not to be reduced by any insurance proceeds received under his independent insurance policy in which the defendant played no part.

The essence of the collateral source rule is the independence of the transaction giving rise to the collateral source, such as the insurance policy. Here, in contrast, the tax benefits, although paid by the government, emanate directly from the tax shelter sought by the plaintiffs and provided by defendants, without which plaintiffs could not have realized any tax benefits. Benefits resulting directly from a transaction under attack must be credited toward the damage award. *See* Jacobs, *The Measure of Damages in Rule 10b-5 Cases*, 65 Geo.L.J. 1093, 1159-60 (1977). Indeed, the SEC has recognized that tax benefits are an inextricable part of real estate limited partnership tax shelter offerings by issuing Guidelines (e.g., SEC Guideline 60, which was in effect during the relevant period in this case) requiring the issuer to disclose the prospective tax benefits that might be realized from the investment. The fact that the tax benefits were paid by the government rather than by the defendants does not lessen the defendants' role in securing them. To hold otherwise would be to confer an undeserved windfall upon the plain-

tiffs. Assuming proof that the $77,500 investment per unit was induced by fraud, not only would they retain the $97,866 per unit already received ($30,000 upon liquidation plus $67,866 tax savings) but they would gain another $47,500 (i.e., the difference between the $77,500 paid per unit and the $30,000 per unit received upon liquidation) for a total of $145,366.

The SEC's further argument that the plaintiffs' tax benefits should not be offset against their damages because the benefits are equivalent to pre-judgment interest must be rejected out of hand. The suggestion that net tax benefits of $63,866 received by the plaintiffs during the period 1977-81 on their investment of $77,500 for the period 1977-79 amounts to pre-judgment interest is so unrealistic and disproportionate as to border on the frivolous. If any pre-judgment interest is due in the present case, the amount can be calculated by the district court. Treatment of tax benefits as interest, aside from being fictional, would be wholly unnecessary.

The Tax Division of the U.S. Department of Justice, also appearing as amicus curiae in opposition to reduction of plaintiffs' recovery by the amount of the tax benefits, does not go as far as the SEC and plaintiffs, both of whom contend that tax benefits should be disregarded as a matter of law in calculating damages recoverable under § 28(a) of the Exchange Act. The Tax Division argues instead that the district court's ruling should be affirmed because the tax benefits in any given case may prove to be illusory: "Depending upon the circumstances of each case, the Internal Revenue Service may challenge the original deductions, the tax treatment required upon sale or other disposition of the investment, and the tax treatment of any damages recovered, all of which may cancel, in whole or in

part, prior tax benefits." Brief at 5. This was the rationale used by the Ninth Circuit in *Burgess v. Premier Corp., supra,* and by the district court in *Western Federal Corp. v. Davis,* 553 F.Supp. 818 (D.Ariz.1982), *aff'd sub nom. Western Federal Corp. v. Erickson,* 739 F.2d 1439 (9th Cir.1984).[6] However, the mere possibility that the I.R.S. may later challenge the plaintiffs' tax benefits is not sufficient for us at this stage of the litigation simply to ignore those benefits. There must first be some showing of facts *in this case* that would justify such a challenge by the I.R.S. So far the government has not pointed to any evidence indicating that the tax benefits were improperly claimed by plaintiffs or that they will be recaptured or offset. None of the immediate parties to this litigation question the legality or amount of the tax benefits.

Despite the fact that plaintiffs took the deductions during the period from 1977-81, thereby giving the I.R.S. several years to challenge them, it has not sought to disallow them. Indeed, the government merely speculates that it "*may*" challenge them some time in the future and that it is possible that they "*could* be denied in whole *or in part*" (emphasis added). Brief at 5. Ignoring its own inaction in the matter the I.R.S. objects to the suggestion that the court might evaluate the issue in this litigation (the course taken by the 8th Circuit in *Austin v. Loftsgaarden, supra,* where an I.R.S. audit was already in progress) on the ground that the court would be "second-guessing" whether and to what extent the tax shelter deductions might be disallowed by the I.R.S. We disagree. The gov-

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[6]Although the plaintiffs cite this court to the results in *Burgess* and *Western Federal Corp.,* they nevertheless reject the rationale of those decisions. The plaintiffs share the defendants' view that the tax benefits are not illusory.

ernment's equivocal position on the issue leaves nothing to be second-guessed. If the I.R.S.'s position is that the plaintiffs are not entitled to the tax benefits they took, its duty is to disallow the deductions rather than attempt to place the issue in limbo indefinitely. Despite ample time for an audit and initial decision it has failed to act.

The government's next argument, that tax losses claimed and taken by the plaintiffs during the Greenspoint Project's early years would be subject to "recapture" by the I.R.S. upon sale of the apartment project at any time prior to expiration of its service period, needs little discussion. Since the building was in fact sold at a substantial loss in 1981, any recapture would already have occurred. Provisions requiring a portion of the gain upon sale to be treated as ordinary income, *see Commissioner v. Tufts,* 461 U.S. 300, 103 S.Ct. 1826, 1829 n. 2, 75 L.Ed.2d 863 (1983), therefore have no application to this case.

Another theory offered by the Justice Department's Tax Division, the "tax benefit doctrine," is equally unpersuasive as a ground for not taking the tax benefits realized by plaintiffs into account in calculating their damages. Under the "tax benefit doctrine" a taxpayer who claims a deduction resulting in a tax benefit for one year and then later obtains a recovery or repayment that is inconsistent with the premise underlying the deduction must include the recovery in ordinary income. *See Hillsboro National Bank v. Commissioner,* 460 U.S. 370, 103 S.Ct. 1134, 75 L.Ed.2d 130 (1983). The government argues that any rescissionary damages recovered by the plaintiffs would be the equivalent of full rescission of their original purchase, putting them in the same position as if they had never owned the tax shelter investment, and that since such recovery would therefore be inconsistent with their claim-

ing deductions as owners the deductions would be offset by income taxes due on their recovery in this action.

The contention that the tax benefit doctrine applies to this case suffers from some basic misconceptions. It fails to distinguish between actual rescission, which is impossible in this case because of the forced sale of the project, and rescissionary damages, which are not the same as rescission and may be awarded when actual rescission is unavailable. *See* 5C A. Jacobs, *Litigation and Practice under Rule 10b-5,* § 260.03(c)(vi)(a) (1984). If this were a case of actual rescission such as *Burgess v. Premier Corp., supra,* which is distinguishable on that ground, the tax benefit doctrine might apply, as was held in that case. In that event, however, the plaintiffs would not be required to amend their prior years' tax returns to eliminate the deductions taken (which the *Burgess* court erroneously assumed) but to report the money judgment later recovered as taxable income. See *Hillsboro National Bank v. Commissioner, supra;* J. Mertens, 1 *Law of Federal Income Taxation* § 7.37. If the district court in the present suit for rescissionary damages concluded, as it would have the power to do, that the tax benefits should be offset against the $47,500 damages claimed, the remedy, although labelled "rescissionary" damages, would not be inconsistent with the plaintiffs' prior tax position. It would not be a return of the plaintiffs to the same position they would have occupied if they had never made the investment but merely an award of damages after crediting them with their tax benefits. In short, the "tax benefit doctrine" does not dictate the district court's decision but depends for its applicability upon the substance of that decision. To hold as the government urges would put the cart before the horse.

Lastly it has been suggested that the tax benefits should not be offset against the plaintiffs' investment because if there had been a full disclosure of Houston's intent to annex the land beneath the Greenspoint Project the Project would never have been built. This circular reasoning ignores the fact that the Project apartments have been built, triggering application of the tax incentives for investing in the costs involved, including financing, construction and operation. Although an increase in these costs might affect the price and ownership of the limited partnership units, depending on the investors' tax brackets and the tax benefits to be realized, there is no record evidence that the Project would not have been constructed if the City's prospective annexation had been revealed and no legal basis has been advanced for refusing to credit the plaintiffs with the tax benefits on the mere speculation that but for the alleged fraud the apartment complex would not have been built.

CONCLUSION

This appeal presents a classic example of the principle that a motion to strike should not be granted when there exist material issues that can only be resolved after the facts are known. Accordingly the order is reversed and the case remanded for further proceedings in accordance with this opinion.

APPENDIX B

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

WILLIAM Z. SALCER, et al.,	:	
Plaintiffs,	:	82 Civ. 5636 (VLB)
-against-	:	ORDER GRANTING PLAINTIFFS' MOTION TO STRIKE
ENVICON EQUITIES CORP., et al.,	:	CERTAIN AFFIRMATIVE DEFENSES OF THE
Defendants.	:	DEFENDANTS, ETC.

Plaintiffs' amended complaint in relevant part, alleges a violation of Section10(b) of the Securities Exchange Act of 1934, as amended, 15 USC § 78j(b) and SEC Rule 10b-5, 17 CFR 240.10b-5, promulgated thereunder, arising out of their purchase of securities in the form of whole or fractional limited partnership interests of Greenspoint Associates, a Texas limited partnership ("Greenspoint").

Defendants assert certain affirmative defenses in their respective answers alleging among other things, that plaintiffs did not suffer any damages because they received tax benefits and cash in excess of the amount of their investment. Pursuant to Rule 12(f) of the Federal Rules of Civil Procedure, plaintiffs moved to strike those affirmative defenses as being insufficient as a matter of law.

On December 9, 1983, David R. Simon, Esq. and Robert H. Jaffe, Esq., attorneys for the plaintiffs; Spengler Carlson Gubar Brodsky & Frischling (Thomas H. Sear, Esq., and Robert Knuts, Esq. appearing), attorneys for defendants Envitex Realty Corp., U.S. Southwest As-

sociates Turning Block Associates and Erving Wolf; Richard W. Schleiffer, Esq., attorney for defendants John W. Galston, Harry W. Burrow, Envicon Equities Corp., Envicon Development Corp. and U.S Properties/Southwest; D'Amato & Lynch (Dennis P. Costigan, Esq. appearing), attorneys for defendant Feit & Ahrens; Solinger Grosz and Goldwasser, P.C. (Bernard Persky, Esq. appearing), attorneys for defendant Blonder, Seymour & Shapps; and Suzanne Antippas, Esq., attorney for defendants William B. Bush, Jr. and Venture Development Group, Inc.; argued that motion before the Court;

And upon reading and filing the notice of motion for an order compelling production of documents of defendants Envitex Realty Corp., U.S. Southwest Associates, Turning Point Associates and Erving Wolf, the notice of joining in said motion by defendant Feit & Ahrens dated September 16, 1983, the affidavit of Thomas H. Sear, sworn to on June 22, 1983, the affidavit of Richard W. Schleiffer, sworn to on June 29, 1983, and the affidavit of Bernard Persky, sworn to on July 8, 1983, the affidavit of Suzanne Antippas, sworn to on June 29, 1983, and the affidavit of Thomas H. Sear, sworn to on September 23, 1983, and the affidavit of Dennis P. Costigan, sworn to on September 16, 1983, all in support of the motion of defendants Envitex Realty Corp., U.S. Southwest Associates, Turning Block Associates and Erving Wolf for an order compelling production of documents; the notice of motion to strike certain affirmative defenses of all defendants, dated August 29, 1983; the affidavit of Thomas H. Sear, sworn to on September 23, 1983 and the affidavit of Dennis P. Costigan, sworn to on September 30, 1983, in opposition to plaintiff's motion for an order striking certain affirmative defenses of all defendants; and all the memoranda of law submitted in regard to these motions;

And the Court having rendered an opinion made part of the transcript of the proceedings on December 9, 1983, and for other good cause shown:

IT IS on this day of January, 1984,

ORDERED THAT:

1. The following affirmative defenses of the defendants in this action are hereby stricken as defenses to the plaintiffs' claim under Section 10(b) of the Securities Exchange Act of 1934, as amended, 15 USC §78j(b) and SEC Rule 10b-5, 17 CFR 240.10b-5, as being insufficient as a matter of law only insofar as they assert or may be construed to assert a defense that plaintiffs have suffered no damages because they received tax benefits and cash in excess of the amount of their investments in Greenspoint;

(a) the fifth and sixth affirmative defenses set forth in the answer to the amended complaint filed by defendants Envitex Realty Corp., U.S. Southwest Associates, Turning Block Associates and Erving Wolf;

(b) the fifth and sixth affirmative defenses set forth in the answer to the amended complaint filed by defendants John W. Galston, Harry W. Burrow, Envicon Equities Corp., Envicon Development Corp. and U.S. Properties/ Southwest;

(c) the tenth and twelfth affirmative defenses set forth in the answer to the amended complaint filed by defenddants William B. Bush, Jr. and Venture Development Group, Inc.;

(d) the seventeenth affirmative defense set forth in the answer to the amended complaint filed by defendant Feit & Ahrens; and

(e) the fifteenth affirmative defense set forth in the

answer to the amended complaint filed by defendant Blonder, Seymour & Shapps.

2. Notwithstanding the foregoing, defendants may show (a) there was a lack of reliance because of the impact that tax benefit expectations had on plaintiffs' decisions to invest in Geenspoint; and (b) that the alleged misrepresentations and omissions were not material in light of these tax benefits. The magistrate will determine the scope of discovery with respect to these and all other issues.

3. The decision set forth in paragraph "1" of this order is hereby certified to the United States Court of Appeals for the Second Circuit for review pursuant to 28 USC §1292(b) as involving a controlling question of law as to which there is substantial ground for difference of opinion and that an immediate appeal may materially advance the ultimate termination of the litigation and otherwise result in saving the resources of the Court and the parties, and in streamlining further proceedings in this action.

4. Defendants have stated that they will file petitions for permission to appeal from this order and, for good cause shown, all proceedings in this action are hereby stayed pending a ruling by the United States Court of Appeals for the Second Circuit on those petitions and, if they are granted, pending a decision on the merits of the appeal from this order.

/s/ Vincent L. Broderick
VINCENT L. BRODERICK, U.S.D.J.

2/2/84

APPENDIX C

Section 28. (a) The rights and remedies provided by this title shall be in addition to any and all other rights and remedies that may exist at law or in equity; but no person permitted to maintain a suit for damages under the provisions of this title shall recover, through satisfaction of judgment in one or more actions, a total amount in excess of his actual damages on account of the act complained of. Nothing in this title shall affect the jurisdiction of the securities commission (or any agency or officer performing like functions) of any State over any security of any person insofar as it does not conflict with the provisions of this title or the rules and regulations thereunder.

APPENDIX D

UNITED STATES COURT OF APPEALS
SECOND CIRCUIT

At a stated term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Courthouse, in the City of New York, on the 15th day of November, one thousand nine hundred and eighty-four.

WILLIAM Z. SALCER, PANFELD, EDELMAN, ET AL., a Texas General Partnership, ROBERT L. ANDREWS, M.D., SANJIVANI C. BAKARE, M.D., et. al.,

Plaintiffs-Appellees,

v.

ENVICON EQUITIES CORP., ENVICON DEVELOPMENT CORP., ENVITEX REALTY CORP., VENTURE DEVELOPMENT GROUP INC., a Texas Corporation, U.S. SOUTHWEST ASSOCIATES, a Texas General Partnership, et. al., No. 84-7183, -7185, -7187, -7189, 7191.

Defendants-Appellants.

A petition for rehearing containing a suggestion that the action be reheard in banc having been filed herein by counsel for the plaintiffs-appellees, William Z. Salcer, et. al.,

Upon consideration by the panel that heard the appeal, it is

Ordered that said petition for rehearing is DENIED.

It is further noted that the suggestion for rehearing in banc has been transmitted to the judges of the court in regular active service and to any other judge that heard the appeal and that no such judge has requested that a vote be taken thereon.

/s/ Elaine B. Goldsmith
Elaine B. Goldsmith
Clerk

APPENDIX E

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

---------- x

WILLIAM Z. SALCER and PANFELD, EDELMAN, et al.,

Plaintiffs,

- against - 82 Civ. 5636

ENVICON EQUITIES CORP., et al.,

Defendants.

---------- x

New York, New York
December 9, 1983, 2:00 p.m.

Before:

HONORABLE VINCENT L. BRODERICK,
District Judge

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THE COURT: I grant plaintiffs' motion to strike those affirmative defenses which in substance are predicated upon the plaintiffs having gotten the benefit of their bargain, because they did receive tax deductions.

I am not striking those defenses which assert that the plaintiffs did not rely upon the representations which are alleged to be false.

Those are in my judgment two very distinct matters, and the defendants will have the right to attempt to establish through discovery and then at trial that the plaintiffs, in investing in these so-called tax shelters, invested despite the omissions, irrespective of the omissions, and would have invested even if the admissions had not been made and the facts had been correctly stated.

There were two parts, as I see it, to the bargain that the plaintiffs received. One was the opportunity to receive currently available but probably rapidly wasting tax benefits or tax deductions or tax shelters.

The second part of the bargain was an investment in a capital resource that ultimately they, the investors, expected to increase in value.

As I understand the allegations in this action, they are that the defendants in inducing the participation of plaintiffs in this venture made certain representations with respect to the investment itself and the dimensions of the investment that were false, and that as a result of that falsity, the investment itself was necessarily terminated at an early date.

This affected a complete cutoff of the expectation that the investors had that they did in fact have a capital investment which ultimately would appreciate in value and ultimately produce income.

During the colloquy which we had, Miss Antippas pointed out that there could very well have been another type of fraud alleged, a fraudulent representation that something was a tax shelter when in fact it was not a tax shelter, and because it was not a tax shelter, ultimately the investors who attempted to take advantage of it, had to regorge the advantage that they took to the government.

This, as I see it, is not that situation. This is a situation where the allegations go to the investment itself and not to its attributes of being a tax shelter.

There is, as the documents which you have filed and the memoranda you have filed indicate, a difference of opinion as to whether in the tax shelter type situation where 10(b)(5) type allegations are made, consideration should be given to the tax benefits received by the plaintiffs in determining the extent of their damage, and it was suggested by one or more of the courts that considered it, that

something in the nature of Alice in Wonderland is involved in those tax considerations, are not taken into account.

I certainly do not intend to indulge in Alice in Wonderland, but it seems to me that the tax considerations come into this case in determining whether there was in fact a fraud committed.

The plaintiffs have argued that since the frauds alleged are frauds of admission, reliance need not be shown, and I think as far as it goes that that is a correct statement of the law.

But it is certainly open to the defendants to show affirmatively that there was a lack of reliance, and the defendants in this case may attempt to establish that there was no fraud by showing affirmatively that there was a lack of reliance on the part of one or more of the plaintiffs here on these statements.

Now, I would assume they will attempt to show this by showing that the prime motivation to the plaintiffs in making this investment were the tax shelter considerations, and so by granting plaintiffs' motion to strike affirmative defenses here, I am not by any means putting out of the case the consideration of what impact, if any, tax benefit exceptions may have had in persuading the plaintiffs to invest.

As a matter of logic, it makes no sense to me, and I am now getting back to my reasons for striking the affirmative defenses, as a matter of logic it makes no sense to me to say that a fraud committed on an investor by selling him an interest which was not worth what it should have been worth if the fraud had not been committed or if the investment was as it was represented to be, it makes no sense to say that any loss to the defrauded investor and

hence, any gain or recovery which he is entitled to should be reduced by the tax benefits that he has realized.

Those tax benefits would have been realized whether or not there was a fraud in this particular situation.

And it is not the presence of those tax benefits or any absence of those tax benefits that is complained about. It is something quite different that is complained about.

It is the disappearance of an investment which was supposed to carry on and become profitable that is being complained about.

The investor who was interested in tax considerations when he invested here could very well have invested in some entirely different company, realized comparable tax benefits, and not suffered the loss that the investors here are alleged to have suffered because of the fraud.

I can actually see no basis upon which a recovery for this fraud should be tempered by an expected tax benefit which would have been there whether or not there was a fraud or should have been there whether or not there was a fraud, and which would have been equally available in any other investment.

Now, gentlemen and ladies, that is my ruling with respect to the plaintiffs' motion to strike defenses. I am going to ask counsel to submit an order on this matter because I would like counsel to consult with one another as to just which of the affirmative defenses is implicated in this ruling.

We will be dealing among other things with Envicon's fifth and sixth defenses, with Feit and Ahrens, I believe its sixth and seventeenth defenses, with Blonder's fifteenth defense, and there is one other, I believe. Well, some of

those defenses that the motion was specifically addressed to may have shaded over into this other area that I have talked about. In other words, they may have shaded over into the area of being an affirmative defense against the allegation of fraud itself, because they are alleging the absence of a second element of reliance, and that's why I would like to ask you to agree on the defenses which have been stricken here.

I think I have made it fairly clear which ones I intend to strike.

So far as the motion with respect to discovery of the plaintiffs, I think my ruling makes it clear that I do not consider that tax information from the plaintiffs is irrelevant to the further progress of this case because it may very well be germane to questions of a particular plaintiff's reliance.

But I have confided to Judge Raby the responsibility for supervising discovery, and consistent with this ruling, I will expect him to continue to do that. He can make his own judgment after due consultation with you gentlemen and ladies, and after proper suggestions from you as to whether the production of tax returns is necessary or whether information can be given, or whether a protective order should be developed. I leave all this to his good judgment.

Does that leave anything open before me?

Yes, sir?

MR. JAFFE: Just one thing.

I don't know, since we won, we wouldn't appeal but if the defendants intend to appeal whether we shouldn't —

THE COURT: Thank you very much. I did mean to say that.

I am not urging anyone to appeal, but if there is to be an appeal here, I certainly believe it would be proper to include in my order a provision under, I believe it is 28 U.S.C., Section 1292, the issue involved here is a crucial issue in this case. It may very well determine whether this case is to proceed or not to to [sic] proceed. It is, so far as I know, a matter of first impression in this district and certainly in this circuit.

Is that responsive to your suggestion?

MR. JAFFE: It certainly is, your Honor, and if counsel agree, certainly defendants indicated interest in appealing, maybe we will work a question to be presented to the Second Circuit on it.

THE COURT: Very well. Thank you.

MR. JAFFE: Thank you very much.

MS. ANTIPPAS: Thank you.

MR. SEAR: Thank you very much, your Honor.

APPENDIX F

Excerpts from Transcript of Oral Argument before District Judge Vincent L. Broderick, December 9, 1983

MR. JAFFE: Your Honor, this hearing comes on, I believe, in effect in response to the memorandum and order of Magistrate Raby on October 12, 1983, where the magistrate suggested that the Court consider the motion to strike affirmative defenses of the defendants relating to the issue of damages in this case, noting at page 2 that counsel for the plaintiffs, and commenting on the affirmative defense, that tax benefits should be used to reduce the damages in this matter.

And as a result thereof, assuming a 50 percent tax rate for each of the named plaintiffs, an assumption which we accept as true for purposes of this motion, that such a holding would mean effectively that the federal government subsidizes fraud. And that is the essence.

* * *

THE COURT: Well, now your interest in dismissing these affirmative defenses at this point is because you don't want to turn over your clients' tax returns, is that not right?

MR. JAFFE: That's not correct, your Honor.

THE COURT: What other interest can you possibly have?

MR. JAFFE: Because, your Honor, the interest in dismissing is to determine whether we should go forward with this case, because if in fact the Court determines that tax benefits, as a matter of law, are to be deducted from

claims made by our clients, it would be our recommendation to our clients that this case is not worth a candle, and we want to be in a position to recommend that.

Because while there may be one or two of the named plaintiffs, due to circumstances beyond their control, that after the year 1977 had experienced such financial difficulty that they could not take the benefits they anticipated taking when they went into this venture, they may have a small claim left even after you take into account the tax benefits. Most of them will not be in that position. Most of them, we submit to the Court, went into this, there is no question about it, went into this investment based in part that they were in a tax bracket where the tax benefits would be significant to them.

So our reason is not simply because we do not want them to turn over their tax returns. Our reason as to whether or not they should go through a litigation, which is still in its inception, which still has a great deal of discovery to be taken from a great number of defendants and, undoubtedly at some point from the plaintiffs, substantial number of plaintiffs, 20 individuals here, whether it is worth their time and effort to go through it because if one or two of them, they have a two or three or $4000 net claim remaining after you apply tax benefits, it may not be worth it to them.

* * *

MR. JAFFE: Your Honor, we have a record. I submit we have a record. I submit that we have agreed with the factual presentation made by the defendants.

I submit that we will stand and stipulate on behalf of our clients that they went into this matter because as represented in a subscription to this limited partnership, they represented that they were 50 percent taxpayers.

There is no question but that they also, among other things, relied upon the fact that this was a tax shelter. We don't dispute it.

For the purposes of this motion, we submit to the Court the defendants are correct as to their factual assumptions. So there is a record here.

A stipulaton of counsel is as much a fact as anything else in the record. We stipulate that because we stipulate — we make the reasoning for our stipulation even more strong — that we have to go back and advise our clients. We have to advise them if there is any value to it, and we have submitted we are going to advise them there is no value to this case, because taking the facts as stated by the defendants in their motion to obtain the tax returns, they are correct.

* * *

In this particular case, the net claim of each of the plaintiffs is exact. We have the amount. They invested $77,500 for a whole unit, a couple of people bought two units, one person bought a fraction of a unit, but the unit was $77,500.

At the time of the forced sale, they obtained a refund of $30,000. That too was reflected appropriately in the schedule prepared by the defendants, and we agree. It's correct. So their loss is now established at $47,500.

However, by virtue of the tax benefits which they obtained, they actually all ended up, assuming the 50 percent tax bracket, with a profit. Assuming that benefit, actually their tax benefits, even at a 50 percent rate, exceeded the $47,500.

So it's not a question of whether there is a factual record here, your Honor.

* * *

THE COURT: Once you decide he went into this for tax benefits, then, the more the fraud, the more the benefits, so he has no recovery.

MR. SEAR: That may or may not be true. I don't think that that's necessarily true, because there are — perhaps the misrepresentations in the hypothetical situation that you are talking about would cause him so much economic loss on an overall basis, the investor would suffer real economic loss.

So what we are saying here is, I think Mr. Jaffe, in his argument, really made the point for us when he said there was no loss.

THE COURT: I don't know how your [sic] answering his argument at all. He is saying, "We have a case here where there is a very, very clear-cut issue of law that has never been decided in this court, never been decided in this circuit, and that the factual record could not be any clearer than it is right now because you have made allegations in your papers that there was an investment, I think of —

MR. SEAR: 77,000.

THE COURT: 77,000. That they realized 40,000, and that they got tax benefits of 67,000. So that they come out with a net plus of, I think, about 20,000. And you allege that in your papers, and you set out your arithmetic and the plaintiff says he is absolutely right. That is setting out in stark form, which we agree to, just what the economic situation is here, that because of the tax benefits, our clients did not actually economically overall lose money.

They made $20,000. But they say you can't do that. You can't consider the tax benefits.

You say, of course, you consider the tax benefits. They say it's a question of law, and we are going to spend two years on discovery here. If they are right, this case goes away.

MR. SEAR: Well, I would submit that that sort of actual concession combined with their legal position does not provide a proper basis for a motion to strike affirmative defenses.

THE COURT: Well, forget about whether it's for a motion to strike affirmative defenses or not. It really turns a motion to strike affirmative defenses into sort of a motion for summary judgment because the facts that would underly them, your argument against striking affirmative defenses is that you shouldn't do it early in the case, and it's a pure question of law.

They say, "Well, we have the underpinnings of the facts there. There is a pure question of law with that underpinning of facts, and it's just like a motion for summary judgment addressed to an affirmative defense.

* * *

THE COURT: See, the people who invested — my logical problem with your position, my logical problem with the court in the Eighth Circuit is that you just can't look at this and say, what was the loss on a netting basis, netting the cash loss against the tax gain, because the people who came into this thing, they did not have a question of coming into this or not coming into it.

They had the question of coming into this tax shelter or some other tax shelter, and whatever tax shelter they went into they were going to get a tax benefit.

And what they are complaining about here is, and they may have a difficult job of proving this, that there was a net principal loss because of the fraud of the defendants. And your argument and the Eighth Circuit's position that you net tax benefits against a fraudulently induced loss just makes very little sense to me.

There is no transaction that anybody enters into that doesn't have — that doesn't have tax considerations. There may not be very many that are sold as hard as this type is sold because of the tax considerations, but it is sort of unique, it seems to me, to be saying that in this one area, we will look at the tax benefits.

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FILED
APR 16 1985
ALEXANDER L. STEVAS
CLERK

No. 84-1447

IN THE
Supreme Court of the United States
OCTOBER TERM, 1984

WILLIAM Z. SALCER, *et al.*,
Petitioners,

vs.

ENVICON EQUITIES CORP., *et al.*,
Respondents.

RESPONDENTS' JOINT BRIEF IN OPPOSITION TO A PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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QUESTION PRESENTED FOR REVIEW

In an interlocutory appeal pursuant to 28 U.S.C. §1292(b), did the United States Court of Appeals for the Second Circuit properly reverse, and remand for discovery and further proceedings, the district court's order, pursuant to Rule 12(f) of the Federal Rules of Civil Procedure, striking affirmative defenses which alleged that tax savings obtained by the petitioners as a result of their investment in a tax shelter venture reduce damages recoverable under Rule 10b-5 and Section 10(b) of the Securities Exchange Act of 1934?

---

* PARTIES

Pursuant to Rule 28.1, the following describes the parent companies, subsidiaries and affiliates of respondents:

Envicon Equities Corp.: Subsidiary of Envicon Development Corp.; affiliate of Envicon Arkansas Realty Corp., Envicon Florida Realty Corp., Envilew Corp. and Envisac, Inc.

Envicon Development Corp.: Subsidiary of Southmark Corporation; parent company of Envicon Equities Corp., Envicon Arkansas Realty Corp., Envicon Florida Realty Corp., Envilew Corp. and Envisac, Inc.

Envitex Realty Corp.: Formerly a subsidiary of Envicon Development Corp., merged into Envicon Development Corp. in 1983.

Venture Development Group, Inc.: Parent company of Southern Property Management Inc., Cypress Park Development Inc., Enclave Development Corp., Maxwell Properties Inc., South Green Development Inc., U.S. Southwest Properties Inc., U.S. Properties Inc., U.S. Properties Southwest Inc., Venture Residential Inc., Venture West Corp., Venture Development Construction Inc., Venture Commercial Development Inc., Venture Community Development Inc., Venture/BT Corp., WBV Corp., South Green Associates Inc., SF Venture Corp. and VDG Land Company Inc.

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IN THE

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RESPONDENTS' JOINT BRIEF IN OPPOSITION TO A PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Respondents Envicon Equities Corp., Envicon Development Corp., Envitex Realty Corp., Venture Development Group, Inc., U.S. Southwest Associates, Turning Block Associates, Feit & Ahrens, William B. Bush, Jr., John W. Galston, Erving Wolf, Harry W. Burrow and Blonder, Seymour & Shapss respectfully request that this Court deny the petition for a writ of certiorari that seeks review of the decision of the United States Court of Appeals for the Second Circuit in *Salcer v. Envicon Equities Corp.*, 744 F.2d 935 (1984).

STATEMENT OF FACTS

No facts have been established in this case. The record before the United States Court of Appeals for the Second Circuit consisted of: (a) the pleadings; (b) motion papers in support of respondents' motion to compel production of documents; (c) motion papers relating to the petitioners' cross-motion to strike certain affirmative defenses; (d) the memorandum of a magistrate relating to respondents' motion for production of documents; and (e) the transcript of the oral argument regarding petitioners' cross-motion to strike certain affirmative defenses, including the district court's decision issued from the bench. Thus, any statement of "facts" at this stage of the litigation can only be a recitation of the allegations set forth in the pleadings.

Petitioners' amended complaint alleges a claim for relief under Rule 10b-5 and Section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act"), 15 U.S.C. §78j(b), and various pendent claims under Section 33 of the Texas Securities Act, Article 27.01 of the Texas Business and Commercial Code, the Texas common law of civil conspiracy, the Texas common law of fiduciary obligations and the New York common law of negligence and professional malpractice[1] According to the amended complaint, in late 1977 and early 1978, petitioners purchased fifteen (15) limited partnership units in the Partner-

[1] In August, 1982, two of the petitioners, William Salcer and Panfeld, Edelman, et al., filed the original complaint in this case as a class action on behalf of all purchasers of limited partnerhsip units in Greenspoint Associates (the "Partnership"). After the original plaintiffs' motion for class certification was denied, an amended complaint was filed on behalf of all petitioners.

ship at a cost of $77,500 per unit. (Opinion, App. 3a)[2] The units were marketed and sold as a real estate tax shelter (Opinion, App. 3a-4a). The Partnership was formed to construct, own and operate a garden apartment complex in Harris County, Texas (the "Greenspoint Project") (*Id.*). In December, 1977, the City of Huston annexed the geographic area in which the Greenspoint Project was located (Opinion, App. 4a). Nearly four years later, in September, 1981, the Partnership sold the Greenspoint Project and petitioners received $30,000 per partnership unit (*Id.*).

Petitioners claim that respondents violated Rule 10b-5 by allegedly failing to disclose to petitioners in the private placement memorandum the proposed annexation by the City of Houston of the Greenspoint Project's location.[3] Petitioners see recissionary damages in the amount of $47,500 per partnership unit.

In addition to the $30,000 in cash that they received from the sale of the Greenspoint Project, petitioners also obtained $67,866 per unit in net tax savings through reductions in their personal income taxes as a result of the deductions generated by their ownerhsip of units in the Partnership (Opinion, App. 14a). In their answers to the amended complaint, all respondents pleaded affirmative defenses stating, in essence, that the substantial tax savings realized by petitioners as a result of their investments should reduce any damages which may be recovered (Opinion, App. 4a-5a).

---

[2]References are to the Petition (Pet.) and the exhibits contained in the Appendix (App.) submitted to the Court by the petitioners.

[3]As noted above, the parties are still barely past the pleading stage in this action. Consequently, the issue of respondents' liability under Rule 10b-5 is contested and has not been tried or decided at this preliminary stage of the litigation.

In June, 1983, respondents moved the district court for an order compelling petitioners to produce documents, including petitioners' federal income tax returns for the years in which they received tax benefits from their investment in the Partnership. Petitioners thereupon cross-moved for a protective order prohibiting production of the tax returns and an order striking the affirmative defenses that alleged that the tax savings resulting from petitioners' investment in the Partnership should be offset against damages (Opinion, App. 5a).

After the conclusion of oral argument but prior to any discovery of petitioners, the district court, from the bench, orally granted petitioners' motion to strike these affirmative defenses from respondents' answers (T, App. 25a-31a). After the district court certified its order and decision as appropriate for interlocutory review under 28 U.S.C. §1292(b), respondents appealed to the United States Court of Appeals for the Second Circuit (Opinion, App. 6a).

The Second Circuit unanimously reversed, expressly holding that the district court erroneously and prematurely granted the motion to strike the affirmtive defenses (Opinion, App. 8a). The Second Circuit held that "further facts must be obtained" before the legal sufficiency of the affirmative defenses could be determined (*Id.*). The Court concluded its decision by declaring:

> "This appeal presents a classic example of the principle that a motion to strike should not be granted when there exist material issues that can only be resolved after the facts are known." (Opinion, App. 18a).

The Second Circuit also discussed generally petitioners' arguments, as well as those of the *amici curiae* – the Securities and Exchange Commission and the Tax Divi-

sion of the United States Department of Justice – concerning the scope of Section 28(a) of the Exchange Act, 15 U.S.C. §78bb(a). However, the holding of the Second Circuit was plainly limited to the propriety of granting the motion to strike the affirmative defenses.

Petitioners subsequently filed a motion for rehearing or rehearing *en banc* before the Second Circuit. The Second Circuit panel denied petitioners' motion for rehearing. In addition, no judge in active service on the United States Court of Appeals for the Second Circuit voted for rehearing *en banc* (Order, App. 24a).

REASONS FOR DENYING THE WRIT

INTRODUCTION

By reversing on procedural grounds the district court's decision to strike certain affirmative defenses and remanding the case for further proceedings, the Second Circuit followed well-settled law concerning the application of Rule 12(f) of the Federal Rules of Civil Procedure ("FRCP"). Petitioners do not argue that there is any conflict among the Circuit Courts of Appeals concerning the proper procedure under Rule 12(f).

The Second Circuit, moreover, clearly limited its discussion of the effect of the receipt of tax benefits on rescissionary damages recoverable under Rule 10b-5 to those cases involving tax shelter investments. Therefore, contrary to petitioners' contentions, the Second Circuit's discussion of this issue expressly was not applicable either to all suits for damages or to all Rule 10b-5 actions.

Finally, the decision of the Second Circuit correctly interpreted both Rule 12(f) of the FRCP and Section 28(a) of the Exchange Act.

ARGUMENT

POINT I

THE SECOND CIRCUIT'S DECISION IS NOT RIPE FOR REVIEW

As noted above, petitioners moved the district court for an order striking the affirmative defenses from respondents' answers prior to trial and prior to any discovery of petitioners in this case (Opinion, App. 7a). The Second Circuit reversed the district court's decision granting petitioners' motion and remanded the case because "further facts must be obtained before the issue can definitely be resolved in this case" (Opinion, App. 8a). The record on appeal to the Second Circuit did not even contain the private placement memorandum or the related financial projections upon which petitioners base their claim of misrepresentation under Rule 10b-5 (Opinion, App. 3a). Because petitioners only sought to strike certain affirmative defenses, neither the district court's order, appealed on an interlocutory basis, nor the Second Circuit's decision, constitute a final judgment in this action.

This Court should not exercise its discretion to grant a writ of certiorari when the factual record in the case sought to be reviewed is incomplete. Rather, in order to adjudicate only those issues which truly represent actual controversies and to refrain from improperly issuing advisory opinions, this Court's general practice has been to grant a petition for certiorari only in a case involving a final judgment. *See Brotherhood of Locomotive Firemen v. Bangor & Aroostook R.R.*, 389 U.S. 327, 88 S.Ct. 438 (1967); *Hamilton-Brown Shoe Co. v. Wolf Bros. & Co.*, 240 U.S. 251, 258, 36 S.Ct. 269, 271 (1916). Here, not only is the decision not a final judgment, but the Second Circuit

found that the record was inadequate to determine the merits of the district court's decision.

Thus, in light of the Second Circuit's remand of this case for further proceedings and because the factual record on appeal was found to be insufficient, the Second Circuit's decision is not ripe for review by this Court.

POINT II

THE SECOND CIRCUIT'S DECISION DOES NOT CONFLICT WITH DECISIONS OF OTHER CIRCUIT COURTS OF APPEALS AND IS SHARPLY LIMITED IN SCOPE

The Second Circuit held that the district court erroously granted petitioners' motion to strike affirmative defenses under Rule 12(f), FRCP, prior to any discovery of petitioners in this case and in the absence of an adequate factual record. As such, this decision does not conflict with decisions of other Circuit Courts of Appeals. *See Lunsford v. United States,* 470 F.2d 221, 229-30 (8th Cir. 1977); *Augustus v. Board of Public Instruction,* 306 F.2d 862, 868 (5th Cir. 1962); *Taylor v. Orton,* 216 F.2d 62, 64 (7th Cir. 1954). The decision was both interlocutory and procedural in nature. The decision did not involve a constitutional question, nor did it finally determine the applicability of Section 28(a) of the Exchange Act to the facts involved in this case.

In their attempt to persuade this Court to review the Second Circuit's decision, petitioners misstate the holding of the Second Circuit, the rationale for that decision, and the procedural basis for the order striking the affirmative defenses. Thus, petitioners have sought to create, and then refute, a decision barely resembling the actual Second Cir-

cuit decision which is printed in full as Appendix A to the petition.

First, petitioners attempt to blur the distinction between a motion to strike affirmative defenses under Rule 12(f) and a motion for summary judgment under Rule 56. Petitioners contend that, rather than having made a motion to strike, they moved for summary judgment dismissing the affirmative defenses.[4]

It is well established, however, that a motion for summary judgment seeking dismissal of an affirmative defense is "clearly improper." *Bernstein v. Universal Pictures, Inc.*, 379 F. Supp. 933, 936 (S.D.N.Y. 1974), *rev'd on other grounds*, 517 F.2d 976 (2d Cir. 1975); *Uniroyal, Inc. v. Heller*, 65 F.R.D. 83 (S.D.N.Y. 1974); *Seacoast Liquor Distributors, Inc. v. Kips Bay Brewing Co., Inc.*, 8 F.R.D. 74 (S.D.N.Y. 1947). In any event, even if petitioners' motion to strike the affirmative defenses could be treated as a motion for partial summary judgment, such a motion should not have been determined prior to any discovery of petitioners. *See National Life Insurance Co. v. Solomon*, 529 F.2d 59, 61 (2d Cir. 1975).[5]

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[4]Petitioners ignore the fact that, even if the Second Circuit's decision could be viewed as a denial of summary judgment, this Court does not normally grant a petition for certiorari to review such a decision. *See Pacific Union Conference v. Marshall*, 434 U.S. 1305, 1306, 98 S. Ct. 2, 3 (1977) (denial of summary judgment not appealable to circuit Court of Appeals or to Supreme Court) (per Rehnquist, Circuit Judge).

[5]In those situations where the court is permitted under FRCP 12(b) and (c) to convert a motion directed to the pleadings into one for summary judgment, the Rules provide that "all parties shall be given reasonable opportunity to present all material made pertinent to such a motion by Rule 56." No such opportunity was granted to respondents and respondents have not yet obtained any discovery in this case.

Second, petitioners misrepresent the reasoning of the Second Circuit in its discussion of the effect of tax benefits on damages recoverable in federal securities actions involving tax shelters. The Second Circuit did not "conceptually divide petitioners' investment in the Partnership into two components . . . ." in reaching its decision, as petitioners contend (Pet. 4). The district court, not the Second Circuit, divided the investment into "tax benefit" and "appreciation" components. The Second Circuit discussed the district court's theory and stated that, even using such a theory, the district court erroneously granted petitioners' motion in the absence of the required factual record relating to those "components" (Opinion, App. 10a-11a).

Petitioners also attempt to distort the scope of the Second Circuit's decision and its impact on federal securities litigation in several significant ways. Most importantly, contrary to petitioners' arguments, the Second Circuit's discussion of the effect of tax benefits on the damages recoverable in Rule 10b-5 actions was not addressed to all federal securities litigation generally. Rather, the Second Circuit's discussion of this issue was expressly limited to claims for rescissionary damages under Rule 10b-5 in cases involving investments in tax shelters (Opinion, App. 8a-11a).[6]

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[6]A tax shelter investment is distinguishable from other investments within the purview of Rule 10b-5 and is one in which the "tax benefits to the partner represent an important tangible economic advantage expected to be derived from his investment regardless whether the venture eventually operates at a profit." (Opinion, App. 10a). The decision of the Second Circuit deals only with investments of this sort and does not contain any implication that the tax consequences of other types of investments are relevant to damages recoverable under Rule 10b-5, other sections of the federal securities laws or damage actions generally.

In addition, petitioners erroneously argue that the Second Circuit's decision will allow fiduciaries to escape responsibility for alleged acts of fraud by reducing the damages recoverable for those fraudulent acts (Pet. 10). In making this argument, however, petititoners completely ignore the fact that the Second Circuit's discussion of the damage issue only concerned petitioners' Rule 10b-5 claim. If any fiduciaries committed any fraudulent act in this case, then petitioners may pursue various remedies in their numerous state statutory and common law claims already asserted in this action.

The final argument regarding the impact of the Second Circuit's decision sought to be raised by petitioners is their claim that the Second Circuit's decision improperly creates a right to discovery of petitioners' federal income tax returns. In making this argument, petitioners ignore the fact that, apart from the Second Circuit's decision, respondents already have that right in this action. The district court expressly recognized that the tax status of the petitioners at the time they decided to invest in the Partnership is relevant to their Rule 10b-5 claim (Order and Transcript, App. 22a, 26a, 28a). Implicit in this ruling is the district court's recognition of respondents' right to explore petitioners' tax history and use of the tax benefits derived from their investment in the Partnership. Petitioners did not seek interlocutory review of this portion of the district court's order. Thus, review of the Second Circuit's decision would not prevent discovery of petitioners' federal income tax returns.

POINT III

THE SECOND CIRCUIT'S DECISION CORRECTLY APPLIED SECTION 28(a) OF THE EXCHANGE ACT TO THE ISSUES IN THIS CASE

Apart from the interlocutory nature of the Second Circuit's procedural decision, its limited scope, and the fact that there is no conflict among the circuits with respect to the decision's holding on the issues involved in this case, the Second Circuit's discussion concerning Section 28(a) of the Exchange Act was correct. All of the arguments raised by the petitioners are addressed and persuasively refuted in the Second Circuit's discussion of Section 28(a) (Opinion, App. 11a-18a).

Section 28(a) of the Exchange Act limits the amount of damages recoverable for violations of the Exchange Act to "actual damages." It is well-established that "actual damages" is equivalent to a plaintiff's "net economic loss," *Marbury Management Inc. v. Kohn,* 470 F. Supp. 509, 516 (S.D.N.Y. 1979), *mod. on other gnds,* 629 F.2d 705 (2d Cir.), *cert. denied sub nom. Wood Walker & Co. v. Marbury Management, Inc.,* 449 U.S. 1101 (1980), and where a plaintiff cannot show that he has suffered any actual pecuniary loss, his claim under Section 10(b) will be dismissed. *See Fershtman v. Schectman,* 450 F.2d 1357, 1361 (2d Cir. 1971), *cert. denied,* 405 U.S. 1066 (1972); *Levine v. Seilon, Inc.,* 439 F.2d 328, 335 (2d Cir. 1971).

The purpose of an award of damages in actions for fraud or deceit is "to place the plaintiff in the position he would have been in if the injury had not occurred." *Harris v. Standard Accident and Ins. Co.,* 297 F.2d 627, 631-32 (2d Cir. 1961), *cert. denied,* 369 U.S. 843 (1962); *Glidden Company v. Hellenic Lines, Ltd.,* 207 F. Supp. 262 (S.D. N.Y. 1962) (award of damages designed to reimburse, not

to enrich), *aff'd,* 315 F.2d 162 (2d Cir. 1963); C. McCormick, *Damages* §121, 449 (1935); Restatement, Second, *Torts* §901 (1979).

Accordingly, a failure to deduct all benefits received by a plaintiff would award the plaintiff a windfall which would be equivalent of an award of punitive damages. Section 28(a) prohibits any award of punitive damages. *Osofsky v. Zipf,* 645 F.2d 107 (2d Cir. 1981); *Byrnes v. Faulkner, Dawkins & Sullivan,* 550 F.2d 1303, 1313 (2d Cir. 1977); *Green v. Wolf Corp.,* 406 F.2d 291, 293 (2d Cir. 1968), *cert. denied,* 395 U.S. 977 (1969).

In this case, the Second Circuit relied on these established principles of law to indicate that, in the context of a tax shelter investment, rescissionary damages sought by a plaintiff in a Rule 10b-5 action may be reduced by the value of the permanent tax saving he received from the investment (Opinion, App. 9a-11a).

The only decision by a Circuit Court of Appeals which held that tax benefits should not be deducted from a damage award involved a case in which the plaintiffs had been awarded actual rescission of their investment. *Burgess v. Premier Corp.,* 727 F.2d 826 (9th Cir. 1984). *Burgess* is, therefore, distinguishable from this case, as the Second Circuit noted at App. 17a. The other Court of Appeals decision on this issue, *Austin v. Loftsgaarden,* 675 F.2d 168 (8th Cir. 1982) *rehearing en banc granted* (October 17, 1984) is consistent with the Second Circuit's discussion of Section 28(a). Thus, there is no conflict among the Circuit Courts of Appeals regarding the treatment of tax benefits in cases involving the possible recovery of rescissionary damages in a Rule 10b-5 action.

Petitioners' arguments concerning the impact of the Second Circuit's decision on the eagerness of investors to file

federal securities claims and the possible differences in damage awards for plaintiffs in different tax brackets ignore the compensatory purposes of Section 28(a). As the Second Circuit stated:

> "The standard established by §28(a) for determining the amount of damages to be awarded is not the egregiousness of the defendants' conduct but the extent of plaintiffs' actual injury. To ignore the sizeable tax benefits actually realized by the plaintiffs would be unrealistic. There is nothing improper or unusual in taking tax considerations into account in determining the amount of damages to be awarded. *See Norfolk & Western Railway Co. v. Liepelt,* 444 U.S. 490, 100 S.Ct. 755, 62 L.Ed.2d 689 (1980); *O'Connor v. United States,* 269 F.2d 578 (2d Cir. 1959)." (Opinion, App. 12a).

CONCLUSION

For the reasons stated, this Court should deny the petition for a writ of certiorari to the United States Court of Appeals for the Second Circuit.

Respectfully submitted,

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April 16, 1985

No. 84-1447

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IN THE
Supreme Court of the United States
OCTOBER TERM, 1984

WILLIAM Z. SALCER, *et al.*,
Petitioners,

vs.

ENVICON EQUITIES CORP., *et al.*,
Respondents.

RESPONDENTS' JOINT SUPPLEMENTAL BRIEF IN OPPOSITION TO A PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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RESPONDENTS' JOINT SUPPLEMENTAL BRIEF IN OPPOSITION TO A PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Respondents Envicon Equities Corp., Envicon Development Corp., Envitex Realty Corp., Venture Development Group, Inc., U.S. Southwest Associates, Turning Block Associates, Feit & Ahrens, William B. Bush, Jr., John W. Galston, Erving Wolf, Harry W. Burrow and Blonder, Seymour & Shapss jointly submit this supplemental brief in opposition to the petition for a writ of certiorari seeking review of the decision of the United States Court of Appeals for the Second Circuit in *Salcer v. Envicon Equities Corp.*, 744 F.2d 935 (1984) ("*Salcer*").

After respondents submitted their joint brief in opposition to the certiorari petition, the United States Court of Appeals for the Eighth Circuit issued an *en banc* decision relating to the issues in this proceeding. As set forth be-

low, *Austin v. Loftsgaarden*, ____ F.2d ____, (8th Cir. July 16, 1985) ("*Austin II*") supports respondents' position that this Court should deny the petition for a writ of certiorari in *Salcer*. A copy of this opinion is annexed as part of Appendix A. See p. 1a.

ARGUMENT

AUSTIN II FURTHER DEMONSTRATES THE LIMITED SCOPE OF SALCER AND THAT SALCER CORRECTLY APPLIED SECTION 28(a) OF THE EXCHANGE ACT TO THE ISSUES IN THIS CASE

As set forth in detail in respondents' joint brief submitted in opposition to the petition for a writ of certiorari, this Court should deny the petition because: (1) *Salcer's* holding expressly concerned only a procedural question involving interpretation of Rule 12(f) of the Federal Rules of Civil Procedure; (b) *Salcer* did not conflict with decisions of other circuit courts of appeals; and (c) *Salcer* correctly applied Section 28(a) of the Exchange Act, 28 U.S.C. §78bb(a), to the issues in this case.

In *Salcer*, the Second Circuit held that "[t]his appeal presents a classic example of the principle that a motion to strike [under FRCP 12(f)] should not be granted when there exist material issues that can only be resolved after the facts are known." 744 F.2d at 944. Accordingly, the Second Circuit remanded the case for further proceedings because the record was incomplete, stating "further facts must be obtained before the [tax benefit] issue can definitively be resolved in this case." 744 F.2d at 939. In sharp contrast, unlike *Salcer*, the decisions in *Austin I*, *Austin II*, and *Freschi v. Grand Coal Venture*, ____ F.2d*____, which

*This recent opinion of the Second Circuit is annexed as part of the Appendix. See p. 33a.

also dealt with the tax benefit issue, were each based on an adequate record which was fully developed after a trial on the merits.

In their petition for certiorari, petitioners argued that the circuit courts of appeals were "hopelessly divided" and that the Eighth Circuit Court of Appeals was itself divided over the question of whether tax benefits should be taken into account in computing the amount of damages recoverable in a securities fraud claim involving tax shelters (Petition, 5, 14). In *Austin II,* however, the Eighth Circuit Court of Appeals, *en banc,* rejected the panel decision of the Eighth Circuit in *Hayden v. McDonald,* 742 F.2d 423 (1984) which had held that tax benefits should not be considered in computing damages in an action for actual rescission under state law. (Slip op. at 7. fn.6.) Rather, *Austin II* affirmed the panel decision in *Austin I,* based, in part, on *Salcer.*

Like the Second Circuit in *Salcer,* the Eighth Circuit in *Austin II* distinguished the decision of the Ninth Circuit in *Burgess v. Premier Corp.,* 727 F.2d 826 (1984) based upon the differing nature of the relief sought therein by plaintiffs. Thus, *Austin II* further demonstrats that there is no conflict between the Ninth Circuit, on the one hand, and the Second and Eighth Circuits, on the other hand, concerning the impact of tax benefits in the calculation of damages in tax shelter litigation under the federal securities laws in which the plaintiffs seek recissionary damages.

CONCLUSION

For the reasons stated in this brief and in Respondents' Joint Brief in Opposition, this Court should deny the petition for a writ of certiorari to the United States Court of Appeals for the Second Circuit.

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September, 1985

APPENDIX A

UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

No. 84-5053

Dr. Roger E. Austin,
Dr. Tom W. Anderson,
Dr. Myrel A. Neumann, and
Dr. William C. Randall,

Appellees,

v.

B.J. Loftsgaarden; Alotel Incorporated, a Minnesota corporation; Property Development and Research Company, a Minnesota corporation and 2361 Building Corporation,

Appellants.

No. 84-5058

Dr. Roger F. Austin, Dr. Tom W. Anderson, Dr. Myrel A. Neumann, and Dr. William C. Randall,

Appellees,

Appeals from the United States District Court for the District of Minnesota

v.

B.J. Loftsgaarden; Alotel Incorporated, a Minnesota corporation,

Appellants,

M.S. Noah; John W. Burg; Lyman H. Coult; Robert R. Dunlap

Property Development & Research Company a Minnesota corporation; and 2361 Building Corporation,

Appellants.

No. 84-5059

Dr. Roger E. Austin, Dr. Tom W. Anderson, Dr. Myrel A. Neumann and Dr. William C. Randall,

Appellants,

v.

B.J. Loftsgaarden; Alotel Incorporated, a Minnesota corporation,

Appellees,

M.S. Noah; John W. Burg; Lyman H. Coult; Robert R. Dunlap

Property Development & Research Company a Minnesota corporation; and 2361 Building Corporation,

Appellees.

Submitted: January 17, 1985
Filed: July 16, 1985

Before LAY, Chief Judge, and HEANEY, BRIGHT, ROSS, McMILLIAN, ARNOLD, JOHN R. GIBSON, FAGG, and BOWMAN, Circuit Judges.

PER CURIAM.

This en banc hearing arises from a retrial on the issue of damages ordered by this Court in *Austin v. Loftsgaarden,* 675 F.2d 168 (8th Cir. 1982) (*Austin I*). In *Austin I,* we affirmed the jury's verdict that Loftsgaarden and three of his closely-held corporations (hereinafter Loftsgaarden) violated state and federal securities laws, but held that the district court erred in ruling that the plaintiff-investors' rescissionary damages could not be reduced by the "tax shelter"[1] benefits they received as a result of their in-

[1]In *Austin I,* we defined "tax shelters" as investments which allow the investor

> to offset certain "artificial losses" (that is, noneconomic losses but losses which are available as deductions under the present tax laws) not only against the income from

vestments. Thereafter, we denied plaintiffs' petition for rehearing or rehearing en banc.

On remand, the district court deducted plaintiffs' tax benefits from their damage awards and both sides appeal. After oral argument before a panel of this Court, the panel issued an order setting two issues for an en banc consideration: First, whether *Austin I* should be reconsidered as it relates to the offset of tax benefits from rescissionary damages awarded in a private securities fraud action involving an investment that was structured and marketed as a tax shelter; and second, assuming that *Austin I* was properly decided, what is the proper measure of plaintiffs' rescissionary damages?

FACTS.

The facts in this case are set forth in detail in *Austin I,* 675 F.2d at 173-76. We briefly review them here.

Plaintiffs Austin, Anderson, Neumann and Randall, invested over $152,000 in Alotel Associates (hereinafter Associates), a limited partnership organized by defendant B.J. Loftsgaarden to help finance the building and operation of a Ramada Inn in Rochester, Minnesota. Loftsgaarden's offering memorandum claimed that purchasers of the limited partnership interests would receive substantial tax benefits during the first three years of their investments and thereafter would share in the hotel's projected profits.

> those investments but also against the [investor's] other income, usually from his regular business or professional activity.

675 F.2d at 183 (citing Staff of Joint Comm. on Internal Revenue Taxation, 94th Cong., 1st Sess., *Overview of Tax Shelters* 1 (Comm. Print 1975)).

The Rochester Ramada opened several months behind schedule in 1974 at a construction cost substantially in excess of that projected. Thereafter, the hotel incurred significant operating losses and Loftsgaarden requested the limited partners to extend to Associates several large loans to prevent insolvency. The limited partners hired a lawyer and an accountant to investigate Loftsgaarden's stewardship of the project, which revealed that Loftsgaarden had knowingly committed several frauds on the limited partners. Although Loftsgaarden resigned as general partner and the limited partners made additional loans,[2] the partnership ultimately defaulted on its obligations and the hotel was foreclosed upon.

The four plaintiffs[3] then filed this securities fraud action against Loftsgaarden. The jury found that Loftsgaarden had violated "section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b); Rule 10b-5, 17 C.F.R. § 240.10b-5; the antifraud provision of the Minnesota Securities Act, Minn. Stat. §§ 80A.01, *et seq.*, 80A.23; and [had committed] common law fraud. The jury rendered an advisory verdict — in which the district court concurred — that defendants were liable for violating § 12(2) of the Securities Act of 1933. 15 U.S.C. § 771(2)." *Austin I,* 675 F.2d at 172 (footnotes omitted). The court applied a rescissionary measure of damages in the amount of the consideration each plaintiff paid for his limited partnership unit or units, prejudgment interest from the date of purchase, and attorneys' fees for plaintifs Randall and Neumann for a total judgment of $273,720.

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[2]The jury found that these advances were not induced by any misrepresentations by Loftsgaarden and thus the plaintiffs could not recover them.

[3]The numerous other limited partners were initially parties to this action but subsequently dropped their claims.

We affirmed the findings of liability, but vacated the award of damages and remanded to the district court, stating "the court committed reversible error in refusing to allow proof of any economic benefits received by plaintiffs on account of the investment and in failing to instruct the jury that the damage award must be reduced by any value shown to have been received by plaintiffs." *Austin I,* 675 F.2d at 181.

On remand, the district court awarded to plaintiffs damages in the amount of their consideration paid, with eight percent interest thereon, less tax benefits received, for a total amount as follows: Anderson, $35,172; Austin, $31,277; Neumann, $39,371; and Randall, $31,569. It also granted attorneys' fees under Minn. Stat. § 80A.23, subd. 2 as follows: Anderson, $0; Austin, $0; Neuman, $29,000; and Randall, $20,000. In addition, the court granted costs of $5,321.83 to Austin, Anderson and Neumann and $2,955.49 to Randall. We now consider the two issues raised before the Court en banc.

DISCUSSION.

I. Should Austin I be reconsidered as it relates to the offset of tax benefits from rescissionary damages awarded in a private securities fraud action involving an investment structured and marketed as a "tax shelter"?

The starting point for our analysis is that the petition for rehearing or rehearing en banc in *Austin I* was denied, 675 F.2d at 168, and that, accordingly, its holdings are now law of the case. As we stated in *Otten v. Stonewall Ins. Co.,* 538 F.2d 210 (8th Cir. 1978):

> Law of the case principles have been stated with clarity and consistency in this court over a

> long pericd of time. "This court has repeatedly held that the decision on former appeal is the 'law of the case' on a question presented in that former appeal, unless the evidence introduced at the subsequent trial is substantially different from that considered on the first appeal, and must be followed in all subsequent proceedings in such case in both district and appellate courts unless that decision is clearly erroneous and works manifest injustice. * * * While this rule of practice is not a limit of power, it is nevertheless a salutary one, and should be departed from only after careful consideration of situations arising in specific cases."

Id. at 212 (citations omitted).

The appellees contend that the damages holding in *Austin I* is "clearly erroneous" and works a "manifest injustice" and thus should be reversed. After a careful review of *Austin I*, the relevant cases, the arguments of the parties and the Tax Division of the Justice Department and the Securities and Exchange Commission, appearing as *amicus curiae*, we abide by our previous decision. In doing so, we note that since our opinion in *Austin I*, the United States Court of Appeals for the Second Circuit has substantially adopted the views that we expressed in that case. *Salcer v. Envicon Equities Corp.*, 744 F.2d 935 (2d Cir. 1984).[4]

Our decision in *Austin I* was based on the principle that: "[D]amages for securities fraud are determined in accordance with the extent to which false and misleading information actually harmed the complaining party." *Austin I*,

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[4] *But cf. Burgess v. Premier Corp.*, 727 F.2d 826 (9th Cir. 1984) (applying different rule in case of actual rescission).

675 F.2d at 180 (citation omitted). We noted that for this reason, the courts typically use the out-of-pocket measure of damages,[5] but that where a rescissionary measure of damages is applied, the "actual damages principle requires that a rescissionary * * * award be reduced by any value received as a result of the fraudulent transaction." *Austin I*, 625 F.2d at 181 (citation omitted). We held that this principle applied not only to the 1933 Act claims and the claim under Minn. Stat. § 80A.23(2),[6] (both of which ex-

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[5]The parties are in dispute over whether the out-of-pocket measure of damages would provide recovery similar to that approved here. *See Salcer*, 744 F.2d at 940 n.5, Brief of SEC at 22-23. We need not address this issue, however. *Austin I* limited its holding to tax shelter cases where a rescissionary measure of damages is applied. 675 F.2d at 183.

[6]In *Hayden v. McDonald*, 742 F.2d 423 (8th Cir. 1984), plaintiffs brought claims under Minn. Stat. § 80A.23(1), which provides that, in an action for rescission and restitution based on the nonregistration of securities in Minnesota, "the purchaser shall be entitled to recover the consideration paid for the security * * * less the amount of any income received on the security." Because the Minnesota courts had not directly addressed the issue, we deferred to the district court's interpretation of "income received" as not including tax benefits. *Id.* at 440-41. We now overrule that decision.

We do not believe that Minnesota could have intended to treat fraudulent sellers more kindly than those who have simply neglected to register their securities. Although the phrase "actual damages" does not appear in subsection (1), the principle that a plaintiff should not be placed in a better position than he would have been in but for the fraud — the principle, in other words, that no recovery in excess of actual damages should be permitted — is plainly implicit in that provision. In actions for rescission based on sales of unregistered securities, the statute says, "the amount of any income received on the securities" is to be subtracted from "the consideration paid for the security together with interest" in computing damages.

Moreover, to allow greater recoveries under subsection (1) than under subsection (2) leads to results that are anomalous in the extreme. Subsection (1) governs not only simple actions for sale of unregistered securities (arising under Minn. Stat. §80A.08), but also actions for misrepresenting that registration of a security means that

plicitly limit damages to the "actual damages" sustained), but also to the common law fraud claim[7] and the claim

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state officials are recommending that security (a practice made unlawful by Minn. Stat. §80A.18). Otherwise, a defendant who tells a buyer that the filing of a registration statement means that the Commissioner of Commerce is recommending purchase of the security registered would be liable for the full amount of consideration paid, and would receive no credit for tax benefits conferred on the buyer, however substantial. But a defendant who commits some other kind of fraud, however flagrant, would receive such credit, solely because the action against him arises under §80A.23(2) instead of §80A.23(1). The Minnesota Supreme Court, of course, can resolve this matter authoritatively and have the last word on the subject.

Our brother Heaney, *post* p. 26, takes the position that "it is bad policy" to reach the *Hayden* issue because it "was not presented to us by the parties" and "we need not decide" it. We would like to explain briefly why we disagree with this statement. The Court en banc was convened to decide whether we should adhere to the panel's decision in *Austin I.* Plaintiffs, seeking disapproval of *Austin I,* argued that it was inconsistent with *Hayden.* We agree. The logical implications of *Austin I,* which is now approved by the Court en banc, are completely inconsistent with *Hayden,* for reasons we have given. The Court en banc is convened infrequently, though perhaps not infrequently enough, and we believe it is good judicial policy to use those infrequent occasions to bring consistency to our case law. If we were to leave *Hayden* on the books, without indicating one way or the other whether it is still good law, we would almost guarantee that the Court en banc would have to meet again when the *Hayden* issue arose, unless, of course, the Supreme Court of Minnesota had, in the meantime, resolved the question, an event the likelihood of which we have no way of estimating. For these reasons, we believe it is a wise use of the Court's time and energy to say now that *Hayden* is inconsistent with the position we now take in *Austin II,* and, therefore, to state unequivocally that *Hayden* is abandoned.

[7]In *Berg v. Xerxes-Southdale Office Bldg. Co.,* 290 N.W.2d 612, 615 (Minn. 1980), the Court implied that tax benefits must be considered in determining damages under a Minnesota common law securities fraud claim, at least where the case involves a limited partnership offering which includes the promise of artificial tax savings. 290 N.W.2d at 615-16. *See* note 4, *supra. See also Weise v. Red Owl Stores, Inc.,* 286 Minn. 199, 175 N.W.2d 184, 187 (1970) (the out-of-pocket rule also governs an award of damges for common law securities fraud).

under section 12(2) of the 1934 Act. Although the 1934 Act does not explicitly limit rescissionary damages to "actual damages" sustained, we noted that:

> Under § 12(2), the defendant guilty of prospectus fraud shall be liable to plaintiff, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, *less the amount of any income received thereon,* upon the tender of such security, or for damages if he no longer owns the security.

Id. at 181 (emphasis in original).

Because we found that section 12(2) implicitly incorporates the "actual damages" principle and that the words "income received" should be construed as including the tax benefits bargained for and received in the special case of a tax shelter investment, we concluded that the plaintiffs' damages must be reduced by the tax benefits they received.

The plaintiffs now contend that we should reconsider both of the above findings of *Austin I.* First, they argue that the "actual damages" language in section 28(a) of the 1934 Act does not justify subtracting tax benefits from awards under section 12(2) of the 1933 Act because section 28(a) applies only to the 1934 Act and the words "actual damages" do not appear anywhere within the 1933 Act. We reject this contention. Although the words "actual damages" do not appear in the 1933 Act, the courts have nonetheless applied the actual damages principle of section 28(a) to bar punitive damages[8] under section 17(a) of

[8]We reject the SEC's argument that the actual damages principle is only intended to prohibit awards of punitive damages or duplicate state and federal recoveries based on the same conduct. *See also Shapiro v. Midwest Rubber Reclaiming Co.*, 626 F.2d 63, 70 (8th Cir. 1980), *7 cert. denied,* 499 U.S. 1079 (1981).

the 1933 Act, *Globus v. Law Research Serv., Inc.*, 418 F.2d 1276, 1278, 1283-86 (2d Cir.), *cert. denied*, 397 U.S. 913 (1970), and have construed the rescission and restitution remedy provided by section 12(2) as substantially equivalent to the damages permitted under section 28(a). *Cf. Affiliated Ute Citizens v. United States*, 406 U.S. 128, 155 (1972). The goal of rescission under section 12(2) is to return the parties to the status quo *ante*, "and hence a plaintiff can recover no more than his or her 'net economic loss,' " *i.e.*, "actual damages." *Salcer*, 744 F.2d at 940; *Austin I*, 675 F.2d at 181; *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38, 49 n.22 (2d Cir.), *cert. denied*, 439 U.S. 1039 (1978);

We also reject plaintiffs' contention that tax savings are neither "income" nor are they "received" within the meaning of section 12(2). They cite *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837 (1975) in support of their argument, but that case is inapposite. The plaintiffs in *United Housing* were tenants who were required to purchase refundable non-interest bearing shares in a non-profit housing cooperative in order to rent a low-cost apartment. After a rent increase was imposed to meet costs, plaintiffs brought fraud claims under the Securities Act of 1933 and the Securities Exchange Act of 1934, alleging that they were misled in the purchase of the shares by misrepresentation in the cooperative's information bulletin. The Court looked to "economic reality," 421 U.S. at 848, in determining that the shares were not securities. It noted that the plaintiffs' purchase of the shares was motivated by a desire to obtain housing, not to make a profit in the sense of a "return on investment." The Court was not persuaded that the plaintiffs expected a profit on their non-interest bearing refundable shares (which were akin to a "security deposit") simply because they were able

to reduce their taxes by deducting that portion of their monthly rental charges which were applied to interest on the mortgage. 421 U.S. at 855. The Court noted that "[e]ven if the tax deductions were considered profits, they would not be the type associated with a security investment since they do not result from the managerial efforts of others." *Id.* 421 U.S. at 856 n.20.

United Housing is not only distinguishable on its facts; if anything, its analysis tends to support our position in *Austin I.* Like the *United Housing* Court, the *Austin I* Court looked to "economic reality" in considering the tax aspects of a tax shelter investment.[9] Additionally, unlike the marginal tax benefits referred to in *United Housing,* the tax benefits in the case at hand were a primary motivation behind the investment and resulted from Loftsgaarden's efforts in structuring and operating the partnership to take advantage of relatively complicated tax rules. *See Salcer,* 744 F.2d at 941 ("plaintiffs' argument that defendants are not entitled to 'credit' for the tax benefits because the latter were 'provided' by the government rather than by the defendants must be rejected * * * [T]hat the tax benefits were paid by the government rather than by the defendants does not lessen the defendants' role in securing them.").

In any event, *Austin I* did not hold that tax benefits re-

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[9]*See also Salcer,* 744 F.2d at 941 ("To ignore the sizeable tax benefits actually realized by the plaintiffs would be unrealistic."); *Bridgen v. Scott,* 456 F. Supp. 1048, 1061 (S.D. Tex. 1978) ("Requiring the jury or this Court to try this case without reference to the tax consequences of the transaction would be requiring the jury and this Court to live in an artificial 'never-never' land. The plaintiffs' position that the tax consequences of this transaction should be ignored is simply not realistic and is tantamount to requesting this Court and the jury to try this case blindfolded.").

ceived are a form of income in a strict accounting sense.[10] Rather, we held that section 12(2)'s requirement that "income received" be deducted in determining rescissionary damages simply reflected that all economic benefits bargained for and received must be deducted from plaintiffs' damages because "the strictly compensatory nature of damages awarded in private securities fraud actions requires that such value be taken into account in determining whether and to what extent damages were inflicted upon plaintiffs." *Austin I*, 675 F.2d at 183.

The plaintiffs claim that their tax benefits have not been "received" must also be rejected because they have stipulated that they have received permanent tax benefits from their investments in Associates. Similarly, we reject the contention of the Tax Division and the SEC that plaintiffs' tax benefits "may" prove to be illusory because they "may" experience recapture upon sale or other disposition of the hotel. All of the plaintiffs in this case have already experienced all possible recapture when the hotel was foreclosed upon in 1978. We also reject, as without a factual basis, the Tax Division's claim that "it is far from clear that all the proper income recognition and recapture provisions were taken into account." Brief of Tax Division at 11. All of the plaintiffs' tax returns from the relevant tax years have already been audited and are now closed.

We also find without merit the Tax Division's claim that, under the "tax benefit rule," the plaintiffs, upon receiving rescissionary damages, will have to amend their prior tax returns to eliminate all tax benefits previously received as a result of their investments in Associates. The

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[10]Loftsgaarden, in an apparent change in strategy, now contends that the tax benefits are not income received but are instead a return of consideration. We address this claim *infra*.

"tax benefit rule" does not require elimination of tax benefits already received. *See Hayden v. McDonald,* 742 F.2d at 440. Rather, it provides that a taxpayer who claims a deduction resulting in a tax benefit one year and who later obtains a recovery or repayment in a later year must include the recovery or repayment as ordinary income in the year of recovery.[11] *See Hillsboro National Bank v. Commissioner,* 460 U.S. 370, 103 S. Ct. 1134, 75 L.Ed.2d 130, 142-44 (1983); *Salcer,* 744 F.2d at 943; 1 Mertens, *Law of Federal Income Taxation,* § 7.34 at 7-115, § 7.37 at 7-130. We need not address the contention of the Tax Division and the SEC that the tax consequences of the rescissionary award will "wash out" any prior tax savings, because we are not presented with such a situation in this case.

The plaintiffs next contend, with support from the SEC, that the collateral source rule requires that Section 12(2) awards not be reduced by tax benefits. This rule "prohibits taking into consideration benefits received from third parties as the result of wholly separate and distinct transactions, such as those received under insurance policies negotiated independently." *Salcer,* 744 F.2d at 941. We agree with the *Salcer* Court that the tax benefits of plaintiffs' investments are not a collateral source because "although paid by the government, [they] emanate directly from the tax shelter sought by the plaintiffs and provided by defendants, without which plaintiffs could not have realized any tax benefits. Benefits resulting directly from a transaction under attack must be credited toward the damage award." *Id.* at 941-42.

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[11] We need not decide whether a different situation might exist in a case involving actual rescission. *See Salcer,* 744 F.2d at 943; *Burgess v. Premier Corp.,* 727 F.2d at 838.

For similar reasons, we reject plaintiffs' claim that we should ignore their tax benefits because otherwise the defendants will unjustly "retain" the consideration previously paid by the plaintiffs. First of all, it does not appear that the defendant has "retained" any of plaintiffs' consideration; rather these monies were paid to the partnership and were invested in the project. Moreover, the purpose of the private civil remedies provided by the federal and relevant Minnesota securities laws is not to penalize defendants, but to compensate plaintiffs for any actual monetary loss. *See id.* at 941. This actual monetary loss cannot be determined without reference to tax benefits bargained for and received.

We also reject the similar argument of *amici* that deducting tax benefits from damages will deprive the government of just tax revenues. The government is entitled only to those revenues which are authorized under the tax laws. These laws create incentives for real estate projects to further public policy objectives, such as the creation of employment, enhancement of the real estate tax base and the local business climate. The Rochester Ramada project met all of the tax code criteria and thus generated the income tax benefits which the plaintiffs enjoyed. This case is therefore very similar to *Salcer,* where the Court stated:

> Nor can we agree with the notion that our ruling makes "the government the banker for fraudulent tax shelter activity," *Burgess v. Premier Corp., supra,* 727 F.2d at 838. As Judge Broderick noted, there was no such activity in this case; the fraud, if any, pertained only to the investment aspects of the Greenspoint Project. The government got the residential development that it hoped to encourage by offering the tax benefits

> taken by the plaintiffs. Thus, it is "banking" precisely what it agreed to "bank." There is no suggestion that the project did not meet federal requirements as a viable housing development entitling its owners to tax benefits.

Id. at 941.

There is no legal justification for awarding a party damages to which he is not entitled merely to provide revenue for the government to tax.

Next, we reject plaintiffs' claim that the consideration of tax benefits in determining rescissionary damages in a tax shelter case creates unnecessary complexities. Our opinion in *Austin I,* 675 F.2d at 183, deals at length with this contention. We noted that "the complexity of evidence relating to plaintiffs' tax savings is not a viable reason for precluding such evidence in light of *Norfolk & Western R. Co. v. Liepelt,* 444 U.S. 490, 100 S. Ct. 755, 62 L.Ed.2d 689 (1980)." *Id.* We cannot agree that the retrial of the damages issue on remand reflects such complexity that *Austin I* must now be reversed.

Finally, plaintiffs and the SEC[12] contend that *Austin I's* tax benefit offset rule discourages private enforcement of the antifraud provisions of the federal securities laws in an area in which the Commission itself is unable to devote substantial resources.[13] While it is unclear that this will be

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[12]The SEC also argues that tax benefits should be considered in computing prejudgment interest, but not in computing damages. We agree with the *Salcer* Court, 744 F.2d at 942, that this argument "is so unrealistic and disproportionate as to border on the frivolous" and "must be rejected out of hand."

[13]Most tax shelter securities are sold in private offerings exempt from the registration requirements of the 1933 Act.

the result of the offset rule because most defrauded tax shelter investors will still be able to obtain at least some damages, we agree with the *Salcer* Court that it is for the legislature, not for the courts, to authorize the award of more than "actual damages" in order to encourage the filing of private damage actions. *Salcer,* at 941. *See also e.g., Alyeska Pipeline Service Co. v. Wilderness Society,* 421 U.S. 420 (1975) (shifting of attorneys' fees by court to create incentives is impermissible).

In sum, we affirm the holding of *Austin I* "that in a private securities fraud action involving an investment structured and marketed as a tax shelter, where a rescissory measure of damages is applied, evidence of any benefit derived by the plaintiff/investor via tax savings must be permitted." *Austin I,* 675 F.2d at 183-84.

II. How should the plaintiffs' rescissory damages be computed?

On remand, the district court first determined the amount of permanent tax benefits received by each of the plaintiffs as follows: Anderson, $29,615.00; Austin, $33,330.00; Neumann, $57,014.00; Randall, $36,404.00. The parties do not contest this finding; accordingly, we adopt these figurese as the amount of tax benefits received by each plaintiff.

The court then determined that each plaintiff was entitled to prejudgment interest at the rate of eight percent simple interest[14] under section 12(2) of the 1933 Act. The interest rate has been approved by the panel opinion announced today along with the *en banc* opinion.

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[14]The court originally ordered compound interest but amended its judgment by ordering simple interest.

The court then determined rescissory damages in accordance with the specific language of section 12(2): "consideration paid for such security with interest thereon less the amount of any income received thereon." Under the district court's amended determination, this computation produced the following results:

Plaintiff Austin

Consideration paid June 6,1973:	$35,000
Simple interest at 8% to February 22, 1984:	$31,277
Subtotal	$64,610
Minus tax benefits:	– $33,333
Total damages:	$31,177

Plaintiff Neumann

Consideration paid August 21, 1973:	$35,000
Plus consideration paid October 19,1973:	$17,500
Simple interest at 8% to February 22, 1984:	$43,885
Subtotal	$96,385
Minus tax benefits:	– $57,014
Total damages:	$39,371

Plaintiff Randall

Consideration paid November 13, 1973:	$35,000
Simple interest at 8% to February 22, 1984:	$28,770
Plus consideration paid 1975:	$ 2,512
Simple interest at 8% to February 22, 1984:	$ 1,691
Subtotal	$67,973
Minus tax benefits:	– $36,404
Total damages	$31,569

Plaintiff Anderson

Consideration paid June 2, 1973:	$35,000
Plus interest at 8% to February 22, 1984:	$29,787
Subtotal	$64,787
Minus tax benefits:	– $29,615
Total damages	$35,172

Although the parties and *amici* suggest several variations from this damage computation formula, we believe they raise only three serious contentions. First, defendant Loftsgaarden argues that, under the section 12(2) damage computation formula, tax benefits are a return of "consideration paid" and thus must be deducted from consideration paid before adding on interest. As the district court noted, this course would drastically reduce the awards to Anderson and Austin and eliminate the awards to Neumann and Randall. We agree with the district court that this approach must be rejected. As we noted previously, *Austin I* did not indicate that tax benefits should be treated as a return of consideration. Instead, in holding that tax savings must be subtracted from damages we quoted section 12(2) and italicized the phrase, *"less the amount of any income received thereon." Austin I,* 675 F.2d at 181. Similarly, in *Hayden v. McDonald,* 742 F.2d at 441, we characterized *Austin I* as "implicitly construing the 'income' language in a federal securities statute to include tax considerations." At least one commentator has also characterized *Austin I* as "classifying tax benefits received by the plaintiff as 'income' within the meaning of section 12(2) of the 1933 Act." Note, *Austin v. Loftsgaarden, etc.,* 16 Creighton L. Rev. 1140, 1151 (1983). *Cf.* S. Banoff, *"To What Extent Will Benefits From Tax Shelters Be Permitted to Offset Rescission Damages?,"* 57 J. Tax'n 154, 156 (1980).

Additionally, whether or not tax benefits may be considered "income" in a strict accounting sense, tax benefits are far more dissimilar to "consideration." Moreover, although we find that section 12(2)'s language "income *received* thereon" may properly be construed as including tax benefits bargained for and received, we do not agree that tax benefits can be considered a "return" of consideration.

Finally, treating tax benefits as consideration returned would, even under Loftsgaarden's calculations, mean that the plaintiffs would not be compensated for their actual damages. For example, using Loftsgaarden's calculations of plaintiff Neumann's net interest cost (as we explain further below), he would receive no damages even though he suffered net economic loss of at least $992.[15] Loftsgaarden no doubt prefers the zero judgment figure to the $992 figure, in part because this would lend substantial support to his argument before the panel that Neumann is not entitled to the $29,000 in attorneys' fees granted by the district court. In short, we cannot agree that the district court erred in refusing to treat the tax benefits as a return of consideration for purposes of determining the order of computation under the formula set forth in section 12(2).

Loftsgaarden next contends that the district court erred in awarding prejudgment interest on the total amount of

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[15]Loftsgaarden's calculations indicate that Neumann invested $52,500, lost $5,506 in opportunity cost on the use of his money at 8% simple interest and received $57,014 in tax benefits for a net economic loss of $992. But subtracting the $57,014 in tax savings from the $52,500 consideration paid, before considering Neumann's opportunity cost in that he did not receive the $57,014 back until several years after he invested the $52,500, Neumann receives zero in damages.

Loftsgaarden cites *Johns Hopkins University v. Hutton*, 297 F. Supp. 1165, 1233 (D. Md. 1968), *aff'd in part and rev'd in part on other grounds*, 422 F.2d 1124 (4th Cir. 1970) as support, but that case is inapposite. In that case, the court treated "repayment of *principal*" as a return of consideration. A repayment of principal bears no similarity to tax benefits received. However, even if we were to change *Austin I's* rationale and treat tax benefits as a return of consideration, plaintiffs at minimum would be entitled to their net opportunity cost in damages. This could be done by reducing the amount of the tax benefits received to present value at the time of the investment using, for purposes of this opinion, the 8% discount rate. We prefer, however, to affirm the district court's treatment of tax benefits as "income received."

consideration paid by each plaintiff from the date paid until February 22, 1984, rather than awarding interest only on the amount of money which each plaintiff was "out-of-pocket" during each year of the investment. We agree. The goal of prejudgment interest is to compensate plaintiffs for the loss of the use of their money. *See Cant v. A.C. Becker & Co.*, 384 F. Supp. 814 (N.D. Ill. 1974); *Chris-Craft Industries, Inc. v. Piper Aircrafter Corp.*, 384 F. Supp. 507, 527 (S.D. N.Y. 1974), *modified*, 516 F.2d 172 (2d Cir. 1975), *rev'd on other grounds*, 430 U.S. 1 (1977). Because plaintiffs were not deprived of the use of the entire amount of their investments over the ten year period, prejudgment interest is due only on the amount of money they were out-of-pocket at any given time. *Gerstle v. Gamble-Skogmo, Inc.*, 478 F.2d 1281, 1307 (2d Cir. 1973) (prejudgment interest should be computed on the "net difference between value of assets given and value received"); *Murphy v. Cady*, 30 F. Supp. 466, 470 (D. Me. 1939), *aff'd*, 113 F.2d 988 (1st Cir.), *cert. denied*, 311 U.S. 705 (1940) (reaching similar result by determining that plaintiff was entitled under section 12(2) "to recover the amount paid for [the security] with interest, less the amount received with interest").

Loftsgaarden has submitted what we find is a reasonably accurate determination of the net interest costs incurred by the plaintiffs taking into account the amount of money invested, and the tax benefits received by each plaintiff during each year of their investment in Associates. These calculations, prepared by John M. Carlson, Certified Public Accountant, are as follows:[16]

[16]These calculations are based on the eight percent rate affirmed by the panel opinion attached at the end of this opinion. These calculations take into account recapture and also net out plaintiffs' interest costs by their interest gains on the amount of ordinary income above the amount of their investments retained in each year because of tax

RANDALL

	Invested	Net Reduction (increase in) Tax Liability Current	Carryback	Balance	Days	Interest Cost (earned) at 8% annum
11/13/73	35,000			35,000	153	1,174
4/15/74		4,499		30,501	365	2,440
4/15/75		21,268		9,233	365	739
4/15/76		10,481		(1,248)	365	(100)
4/15/77		10,272		(11,520)	365	(922)
4/15/78		7,297		(18,817)	365	(1,505)
4/15/79		(21,855)		3,038	365	243
4/15/80		4,442		(1,404)	1,339	(412)
12/15/83	35,000	36,404		(1,404)	3,682	1,657

ANDERSON

6/2/73	35,000			35,000	317	2,432
4/15/74		11,221		23,779	365	1,902
4/15/75		17,149		6,630	365	530
4/15/76		10,987		(4,357	365	(349)
4/15/77		11,011		(15.368)	365	(1,229)
4/15/78		7,972		(25,340)	365	(1,867)
4/15/79		(35,974)		12,634)	365	1,011
4/15/80		7,249		5,386	1,339	1,580
12/15/83	35,000	29,615		5,385	3,846	4,010

benfits conferred by their investments in Associates. These calculations also assume that each plaintiff did not receive the tax benefits until April 15 of each year, when their tax returns were due. Although this does not take into account the benefits of potential reduced payments of estimated tax, we find that the calculations present a reasonably accurate and straightforward method of determining net prejudgment interest costs.

NEUMANN

8/21/73	35,000			35,000	58	445
10/19/73	17,500			52,000	178	2,048
4/15/74		19,560		32,940	365	2,635
4/15/75		9,848		23,092	365	1,847
7/15/75			3,677	19,415	91	387
4/15/76		14,431		4,984	274	299
4/15/77		4,888		96	365	8
7/15/77			77	19	91	
4/15/78		9,000		(8,981)	274	(539)
4/15/79		(5,263)		(3,745)	365	(299)
4/15/80		769		(4,514)	1,339	(1,325)
12/15/83	52,500	53,260	3,754	(4,514)	3,765	5,506

AUSTIN

6/26/73	35,000			35,000	293	2,248
4/15/74		13,066		21,934	365	1,755
4/15/75		19,259		2,675	365	214
4/15/76		10,863		(8,188)	365	(655)
4/15/77		3,324		(11,512)	365	(921)
4/15/78		7,646		(19,158)	365	(1,533)
4/15/79		(26,274)		7,116	365	569
4/15/80		5,449		1,667	1,339	489
12/15/83	35,000	33,333		1,667	3,822	2,166

SUMMARY

	Invested +	Interest Cost −	Tax Benefit =	Damages and Interest
Randall	35,000	1,657	36,404	253
Anderson	35,000	4,010	29,657	9,395
Neumann	52,500	5,506	57,014	992
Austin	35,000	2,166	33,333	3,833

Next, both plaintiffs and defendants contend that in order for the plaintiffs to be truly made whole, and to be returned to the status quo ante, both the tax benefits received *and* the tax consequences of their recovery must be taken into account. *Dicta* in *Hayden v. McDonald,* 742

F.2d 423, 440 (8th Cir. 1984) supports this contention, and, as the parties are in agreement, we agree that the tax consequences of plaintiffs' recovery must be considered. The parties disagree on how these tax consequences should be determined. We find Loftsgaarden's method to be reasonably accurate and much simpler than plaintiffs' formula and thus adopt Loftsgaarden's method. This method, which was also used in the "Reardon Report," which was cited in *Hayden,* takes into account the fact that, because each plaintiff will have to pay taxes on his award, the award must be calculated in an amount which each plaintiff would have to recover in order to "net out" their actual damage figure. We assume that each plaintiff is still in the fifty percent tax bracket and thus must receive twice the above amount of damages and net interest cost. Thus, in accordance with the panel's affirmance of the eight percent simple interest rate, each plaintiff is entitled to a damage award as follows: Anderson ($9,395 x 2 = $18,790); Austin ($3,833 x 2 = $7,666); Neumann ($992 x 2 = $1,984); Randall ($253 x 2 = $506).

In conclusion, the Court *en banc* affirms *Austin I* but vacates and modifies the district court's award of damages as set forth above.

There are three remaining issues which were initially heard by a panel of this Court. These issues are: (1) Whether the district court, on remand, erred in its interpretation of *Austin I;* (2) whether attorney fees should have been awarded; and (3) whether prejudgment interest was properly calculated. For convenience, the panel's opinion is incorporated herein:

Before LAY, Chief Judge, and ROSS and McMILLIAN, Circuit Judges.

Plaintiffs urge, on cross-appeal, that the district court should have allowed them to retry their case on the "out of pocket" damages theory. At the original trial the district court noted that "out of pocket" and rescissionary damages are essentially the same. However, plaintiffs hoped to avoid the *Austin I* mandate to consider tax benefits by changing to the "out of pocket" approach. On remand, the district court refused to allow the change in theories. We find no error. The plaintiffs tendered their shares to defendants shortly before the original trial and effectively elected the remedy of rescission. More importantly, plaintiffs should not be allowed to introduce a new theory some eight years later. The case is now in its second appeal, after two trials, both of which focused on rescissionary damages. We think it too late to change theories and find no abuse of discretion by either trial judge.

Plaintiffs also argue that *Austin I* applies only to investments "expressly structured and marketed as a tax shelter." *Austin I,* 675 F.2d at 183. According to plaintiffs no factual finding has ever been made that this particular investment was expressly structured and marketed as a tax shelter. The *Austin I* court defined a tax shelter as any investment which creates tax deductions through "artificial losses." *Id.* The court en banc has endorsed that definition. *Austin II,* slip op. at 3. The evidence shows plaintiffs were able to reduce their tax liability significantly in the first few years of the investment through accelerated depreciation and other deductions.

There are several contentions relating to attorney fees. Defendants contend Neumann and Randall failed to prove a cause of action which would support any award of fees and, even if they did, the amount awarded was excessive. Plaintiffs argue that the fees awarded were insufficient

and, furthermore, that fees should have been awarded to Austin and Anderson.

First, the method of damage calculation determined by the court en banc makes it clear Neumann and Randall were damaged and proved a claim for relief. We find the award of fees to Neumann and Randall falls within the range of discretion of the district court. In weighing the arguments we find no abuse of discretion.

Second, plaintiffs cannot recover fees under federal securities statutes. The award to Neumann and Randall was based on Minn. Stat. § 80A.23(2) (1984). This statute was not in effect before August 1, 1973. It is clear from the record that Anderson and Austin purchased their securities prior to that date. Under these circumstances the district court was correct in holding that Anderson and Austin were barred from recovery of attorney fees.

The issue of the method of calculating interest has been resolved by the court en banc. Plaintiffs have argued that the rate, eight percent, was too low. Defendants, on the other hand, argue no interest can be awarded to Neumann and Randall because they suffered no actual damage and thus failed to prove a cause of action. As noted previously, the court en banc's method of damage calculation shows Neumann and Randall did suffer damage and proved a cause of action. While the district court, on remand, was not bound by the original trial judge's use of eight percent as the rate of interest, plaintiffs point to no evidence in the record which would suggest a higher rate. Although we believe the rate of interest should be based on a finding of fact from evidentiary proof, in the absence of such proof we feel the district court did not err in applying an eight percent rate as a traditional and fair rate of interest.

The panel holds that the district court, on remand, correctly interpreted *Austin I* and did not err or abuse its discretion in the award of attorney fees and pre-judgment interest. In conclusion, we remand to the district court for entry of judgment as set forth in this opinion.

HEANEY, Circuit Judge, concurring and dissenting.

I concur in the majority's opinion except insofar as it overrules *Hayden v. McDonald,* 742 F.2d 423 (8th Cir. 1984). I continue to believe that the issue is a doubtful one and that in cases of doubt we should give great weight to a decision of a United States District Court interpreting a statute of the state in which it sits. Moreover, I think it is bad policy to reach an issue that was not presented to us by the parties and which we need not decide.

LAY, Chief Judge, dissenting, joined by BRIGHT, Circuit Judge.

I incorporate my concurrence in *Hayden v. McDonald,* 742 F.2d 423, 441-42 (8th Cir. 1984), and the reasoning set forth therein for urging that tax benefits of plaintiffs in a rescissionary damage action have no relationship to their present claim. The Department of Justice and the Securities and Exchange Commission have presented strong arguments against appellants' theory in amicae briefs.

The majority invokes the doctrine of law of the case. As Judge Learned Hand observed many years ago: "[I]t is now well settled that the 'law of the case' does not rigidly bind a court to its former decisions, but is only addressed to its good sense." *Higgins v. California Prune & Apricot Grower, Inc.,* 3 F.2d 896, 898 (2d Cir. 1924). A court should never be constrained by the weight of a prior er-

roneous decision. The purpose of an en banc hearing is to draw on the wisdom of the full court and rectify earlier errors. Reliance on precedent is a poor substitute for analysis.

The damages provisions of the federal statute, section 12(2) of the Securities Act of 1933, 15 U.S.C. § 771(2), and the Minnesota statute, Minn. Stat. § 80A.23(1), are quite similar:

> § 12(2): * * * recover the consideration paid for such security with interest thereon, less the amount of any income received thereon * * *.
>
> § 80A.23(1): * * * recover the consideration paid for the security together with interest at the legal rate, costs, and reasonable attorney's fees, less the amount of any income received on the securities.

The key words are "less the amount of any income received * * *." The majority concedes that the tax benefits received by plaintiffs are not really "income." Nonetheless, the court holds the benefits must be subtracted — notwithstanding the clear language of the statute — in order to give meaning to "actual income." As Judge Arnold notes in his concurrence, the present holding as to Minnesota law cannot be rationally squared with *Hayden*.

Loftsgaarden relies heavily on *Salcer v. Envicon Equities Corp.*, 744 F.2d 935 (2d Cir. 1984), *cert. pending*. The *Salcer* court was concerned the plaintiff might receive a windfall and, like the majority today, applied the tax benefits in favor of the defendant, transferring any possible windfall to the wrongdoer. The Ninth Circuit has held to the contrary, using the same reasoning I urge this court to adopt. *Burgess v. Premier Corp.*, 727 F.2d 826, 837-38

(9th Cir. 1984). The *Burgess* court found that "to simply subtract the tax benefits from damages would place an unfair burden on taxpayers generally. * * * Such a result leaves the government bearing the cost of defendants' fraud." *Id.* at 838. *See also Western Federal Corp. v. Erickson,* 739 F.2d 1439, 1444 (9th Cir. 1984).

Application of tax benefits to lessen damages in a rescissionary suit actually fails to comprehend the principle behind a "tax shelter." The investor receives no money from the tax benefit; the investor simply is allowed to deduct a certain amount from his ordinary income or apply a credit toward tax owed for the particular tax year. The actual value of the benefit depends on the income bracket the investor is in, which in turn depends on other deductions that may be available to the taxpayer that year. This fact alone demonstrates how speculative any benefit in tax savings may be. More significantly, the tax benefit is not a real or actual savings – it is usually only a deferral of tax. Ultimately, in a time of recapture when the investment is sold or otherwise disposed of, the taxpayer must return to the government tax benefits gained unless the investor suffers an actual loss. The court's conversion of the tax deferral to realized income by subtracting it from a plaintiff's damages provides a windfall to the defendant – the fraudulent party. The holding in this case violates the old principle that "[i]t is more appropriate to give the defrauded party the benefit even of windfalls than to let the fraudulent party keep them." *Janigan v. Taylor,* 344 F.2d 781, 786 (1st Cir.), *cert. denied,* 382 U.S. 879 (1965), *quoted in Myzel v. Fields,* 386 F.2d 718, 747 (8th Cir. 1967), *cert. denied,* 390 U.S. 951 (1968).

In mitigation, the majority believes Loftsgaarden did not benefit from any of the consideration paid by plain-

tiffs. This is patently wrong. There was evidence at trial showing Loftsgaarden received over $100,000 profit from the investment scheme. Under the majority's approach, Loftsgaarden gains both his own profit from the scheme and the advantage of plaintiffs' speculative tax benefits. Such a result seriously undercuts the broad protective purpose of the Securities Act of 1933. *See United States v. Naftalin,* 441 U.S. 768, 774-777 (1979).

The majority adopts the magnanimous suggestion in Loftsgaarden's brief that, in all fairness, plaintiffs' ultimate damages should be doubled in order to offset the tax consequences of recovery – assuming plaintiffs are in the fifty percent bracket. This serves to demonstrate how speculative and inaccurate the consideration of tax consequences can be in a suit involving rescissionary damages. A defendant should not have to pay damges based on the plaintiff's tax bracket in a given year. This is not a damage caused by the defendant. Their theory is that to make plaintiffs whole and restore the status quo ante we must account for the tax treatment of plaintiffs' recovery. However, the relevant statutes clearly require the court to restore the consideration paid to the defrauding party, with interest, less any income actually received from the investment. And tax benefits concededly are not income received from the investment! Consideration of tax benefits involves the court in the problems of recapture and net gains or losses. In turn, the court finds it must consider each plaintiff's income and deductions in the year of recovery to net out "actual damages" based on applicable tax rates. Rather than making up an artificial

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[1] If depreciation deductions were actually "income," then every taxpayer who takes such a deduction would have to include it as gross income on the next year's tax return, rather than applying it to the property's basis.

theory of damage by doubling the net gain, it is much simpler and more accurate to provide the plaintiff with restitution of his investment. The statutes provide a clear and simple formula. For example, Anderson invested $35,000 for a period of seven years. Loftsgaarden paid Anderson no interest or dividends and returned no principal. Anderson should recover $35,000 with interest for those seven years. Anderson will have to pay tax on the interest at ordinary income rates. In addition, he may be required to recapture past benefits. The tax transaction is between Anderson and the government and should not affect Loftsgaarden's liability. By this method a plaintiff recovers exactly what he lost: the principal, and interest he would have earned had that principal been invested in a legitimate security.[2] This procedure is far more simple than requiring trial courts to undertake complicated and speculative evidentiary hearings on the mechanics of tax deferral plans and plaintiffs' tax status in given years of investment.

Today's holding provides the wrongdoer a surety by which to avoid liability, allowing the fraudulent party to use the United States Treasury for security in any fraudulent transaction. To the extent a defendant can, by his wrongful act, create a tax loss for the innocent victim, the defendant will be allowed to escape liability, shifting the burden of the loss onto the government. I do not believe

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[2]It is reasonable to assume that if plaintiffs had not invested in Loftsgaarden's fraudulent scheme, they would have invested in another legitimate project which would have returned similar tax benefits as well as principal and interest over the life of the investment. The majority's approach will not make plaintiffs truely whole because the tax benefits are subtracted from the return of principal and interest.

section 12(2) or section 80A.23(1) was designed to accomplish this result. Accordingly, I dissent.

A true copy.

Attest:

CLERK, U.S. COURT OF APPEALS, EIGHTH CIRCUIT.

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

Nos. 487, 509, 611 — August Term, 1984

(Argued: January 9, 1985 Decided: July 5, 1985)

Docket Nos. 84-7726, 84-7740, 84-7764

WILLIAM FRESCHI, JR., as Trustee of WILLIAM FRESCHI TRUST,

Plaintiff-Appellee, Cross-Appellant,

—v.—

GRAND COAL VENTURE, BANDLER & KASS, GROUND PRODUCTION CORPORATION, WILLIAM J. WERNER, JACK MITNICK, ROBERT SYLVOR, WILLIAM C. SHERR, MINERAL RESOURCES DEVELOPMENT, INC. and H. JEAN BAKER,

Defendants,

GRAND COAL VENTURE, BANDLER & KASS, GROUND PRODUCTION CORPORATION, WILLIAM J. WERNER, JACK MITNICK, ROBERT SYLVOR, H. JEAN BAKER and WILLIAM SHERR,

Defendants-Appellants, Cross-Appellees.

Before:

MANSFIELD, NEWMAN, and PECK,* *Circuit Judges.*

* Of the Sixth Circuit Court of Appeals, sitting by designation.

Appeal from a judgment of the District Court for the Southern District of New York (Robert W. Sweet, Judge) holding defendants Ground Production Corporation, Bandler & Kass, Werner, Mitnick, Sylvor, Sherr and Baker liable for Rule 10b-5 violations, and defendants Ground Production Corporation, Bandler & Kass, Werner, Mitnick, Sylvor, and Baker liable for fraud, and awarding $266,500 in damages, plus pre-judgment interest.

Finding of liability as to Mitnick on 10b-5 count reversed; other findings of liability affirmed; damages reduced to $77,818; remanded for further proceedings.

Neil Schwarzfeld, New York, N.Y. (Alan C. Fried, Schwarzfeld, Ganfer, Shore & Rosenblum, New York, N.Y. on the brief), for defendants-appellants, cross-appellees.

Robert C. Gerrard, Boston, Mass. (Edward N. Perry, Bowker, Elmes, Perkins, Mecsas & Gerrard, Boston, Mass. on the brief), for plaintiff-appellee, cross-appellant.

JOHN W. PECK, *Circuit Judge:*

This is a securities fraud case. Following a jury trial, defendants Ground Production Corporation, Bandler & Kass, William J. Werner, Robert Sylvor, William C. Sherr, H. Jean Baker, and Jack Mitnick, appellants herein,[1] were found liable for violation of Securities and Exchange Commission Rule 10b-5, and all defendants except

[1] The briefs list Grand Coal Venture as a defendant-appellant. Grand Coal Venture, an unincorporated entity, was named as a defendant; there was, however, no finding of liability against it, and it is therefore not a party to the appeal.

Sherr were found liable for common law fraud as well. They were ordered to pay plaintiff-appellee William Freschi, Jr., trustee of the William Freschi trust, $266,500 in damages, plus $126,681.75 in pre-judgment interest. *Freshchi* v. *Grand Coal Venture*, 588 F. Supp. 1257 (S.D. N.Y. 1984). Defendants have appealed, and Freschi has cross-appealed. We affirm the trial court's judgment of liability as to all defendants except Mitnick; the judgment against him is reversed as to Rule 10b-5 but affirmed as to fraud. We also partially reverse the award of damages on the basis of our decision in *William Z. Salcer, Panfeld, Edelman* v. *Envicon Equities Corp.*, 744 F.2d 935 (2d Cir. 1984), which had not yet been decided when judgment was entered by the district court.

I.

A.

The events leading to this trial began in the summer of 1977, when William Freschi, Sr., the father of plaintiff-appellant, decided to seek a tax shelter for $2,700,000 he had realized from the sale of his interest in a business. Accordingly, he established a trust with his son, William Freschi, Jr. ("Freschi"), as trustee. Freschi decided to invest the trust corpus, which consisted principally of the funds realized from the sale of the business, in operations paying a moderate to high rate of return while offering substantial tax benefits.

A securities salesman suggested that Freschi invest in Spruce Productions, Inc., a venture being organized by appellants Werner, Sylvor, and Sherr. Werner, Sylvor, and Sherr were partners in a law firm, Bandler & Kass, which represented an entrepreneur, Joseph Laird, who was under investigation by the Securities and Exchange

Commission ("SEC") for marketing of fraudulent coal leases. Knowing that the SEC "wanted to put Laird out of business," the three partners decided to take Laird's place in marketing the leases if Laird were forced to cease marketing them. The partners began doing so, through an entity called Spruce Productions, Inc., at least as early as December 1, 1977. The Spruce Productions prospectus contained an express warranty that, if the leased property did not contain recoverable coal reserves, the sponsors of the offering would provide substitute property that did contain such reserves. In the prospectus, the sponsors also promised to buy at least 25% of the coal mined at a profit to the investor and to provide free legal representation to investors in the event that IRS disallowed projected tax deductions. On December 8, 1977, with the mutual consent of the SEC, Laird, and other parties not involved in this suit, the United States District Court for the Central District of California issued a temporary restraining order. The order barred Laird and certain other parties, including his attorneys, from marketing unregistered coal leases to the public. *Securities and Exchange Commission* v. *Cal-Am Corp.*, No. 77-4586 (C.D. Cal. Dec. 8, 1977) (T.R.O.) Werner was personally served with a copy of the order on December 14, 1977.

At this time, Freschi had already decided to invest in Spruce Productions.[2] Werner, Sylvor, and Sherr were

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[2] Freschi wrote a check for $130,000 made out to "Bandler & Kass, Special Account" on December 12, 1977. With it he enclosed a handwritten signed note to "Mr. Werner," stating that the check was "to sub lease [sic] coal land and to obtain an advance royalty payment writeoff [sic]." Freschi held the check, however, until December 19; at this time he mailed it to an agent in New York, who tendered the check to Bandler & Kass under circumstances detailed below.

aware of the difficulty in accepting his investment without violating the T.R.O., but wished to find a way around the problem. As a result, they decided to scrap Spruce Productions and to replace it with another entity offering substantially the same leases through dummy corporations, thus avoiding the T.R.O.'s bar on sales to the public. Werner thus informed Freschi, in a December 15, 1977 telephone conversation, that the Spruce Productions offering was being withdrawn, but would be replaced by a very similar offering. The reason for the change, Werner told Freschi, was that he had just met with IRS officials and it had proved necessary to revise the offering to conform with new IRS regulations. No such meeting with IRS officials, in fact, had occurred.

Werner, Sylvor, and Sherr then formed a company known as Ground Production Corporation. Ground Production procured Laird's coal leases from a new company called Tristar Coal Corporation, which we conclude Laird had formed in an attempt to circumvent the T.R.O. Werner, Sylvor, and Sherr also formed an unincorporated organization known as Grand Coal Venture, which in turn obtained coal leaseholds from Ground Production. To assist them in their work, Werner, Sylvor and Sherr hired H. Jean Baker, a self-styled "geologist" without formal training in geology. Baker, a former associate of Laird's, signed a report stating that there was a strong likelihood that the leased lands contained large coal reserves.

Freschi, relying on the previous assurances that the Grand Coal Venture offering was essentially the same as the earlier Spruce Productions offering, took steps to invest in Grand Coal Venture. At this point, no one had told Freschi of Laird's difficulties with the SEC or of the

temporary restraining order; Freschi's assumption was that Werner had truthfully told him the deal was being restructured due to tax problems. Freschi took independent action to verify the soundness of the projected investment. He consulted an accountant, had the trust's attorney call Werner to discuss the deal and its tax consequences, and retained an agent to verify that Bandler & Kass was a reputable law firm. This agent was satisfied by his investigation, and acting on behalf of Freschi, tendered a check for $130,000 of the trust's funds to Bandler & Kass as the first installment of payments to Grand Coal Venture which eventually were to total $266,500. This first payment was made on December 21, 1977; the documents evidencing the trust's investment were dated December 29, 1977.

Freschi did not receive Grand Coal Venture's offering memorandum until March 31, 1978. This memorandum revealed that, in spite of Werner's earlier assurances about the similarity between the Grand Coal Venture offering and the Spruce Productions one, there were some rather significant differences. Most significantly, the Grand Coal Venture offering lacked the assurances the earlier offering had contained about the profitability of the venture, and indeed contained specific caveats as to the riskiness of the investment. The memorandum, which was a long and complex document (totalling 167 pages), also contained what appeared to be substantial similarities to the Spruce Productions offering: it dealt with coal leases in the same general region, it contained figures at the outset purporting to set forth the "total minimum" return on the investment, and, most importantly, to Freschi, it offered the same tax advantages as had the original offering. The memorandum also incorporated Baker's optimistic "geologist's report."

Upon receiving the memorandum, Freschi began a further investigation designed to insure that his investment was a viable one. His investigation included consultations with his accountant, his attorney, Sherr, a coal mining executive, an attorney specializing in coal leases, and a geologist, who accompanied Freschi to a meeting with Baker. The investigation took place over a period of three months and involved trips from Freschi's home in San Francisco to New York and Denver as well as communications by telephone and mail. Nothing in this rather thorough investigation suggested to Freschi that he was the victim of fraud.

In August, 1978, Jack Mitnick, who acted as "Venture Administrator" for Grand Coal Venture, sent investors a letter, drafted by Sylvor, stating that the leased land did not contain commercially recoverable quantities of coal. The letter further stated, however, that Grand Coal Venture's sublease from Ground Production contained an express warranty that Ground Production would, under such circumstances, give Grand Coal Venture replacement leases containing commercially recoverable coal reserves—a statement which was not true. "Accordingly," the letter continued, "demand has been made of Ground that it immediately furnish you with suitable subleases . . . containing economically recoverable coal reserves . . ." Ground Production actually did give Grand Coal Venture a replacement lease, similarly worthless, in December 1978. Mitnick and Werner continued to assure Freschi that all was well at regular intervals through December 1980. The trust, however, never received any profits on its investment. Finally, Freschi, his patience exhausted, filed the instant suit on July 13, 1981, in the United States District Court for the Southern District of New York.

B.

Freschi was, as we have noted, interested in Grand Coal Venture largely as a tax shelter. At the time of his investment, the tax laws offered large deductions for coal mining investments, as part of a national policy of developing American energy self-sufficiency.

Because Freschi's father was the sole beneficiary of the trust, the trust was not a separate taxpaying entity; all taxes on trust income were assessed directly against the senior Freschi, but paid from the trust corpus. Freschi's father claimed tax deductions for Grand Coal Venture of $320,000 in both 1977 and 1978. These deductions reduced his tax bill for the two years by $337,033.66 and $322,813.01, respectively. IRS ultimately disallowed these deductions and assessed a deficiency against the senior Freschi. It also assessed an interest penalty of approximately $264,500. IRS eventually allowed the senior Freschi, however, to claim a deduction for 1977 for his $266,500 lost investment. This deduction resulted in total federal and state tax savings for the elder Freschi of $188,682. Thus Freschi's actual out-of-pocket loss on his investment was $77,818; because of the failure of his tax shelter he was required to pay IRS $639,846.67 on account of the disallowed deductions, plus the $264,500 interest penalty.

C.

Freschi's suit against Grand Coal Venture and its various principals and agents was tried before a jury in May 1984.[*] The jury returned a special verdict form

[*] Prior to trial, the court dealt with various motions; *inter alia*, the court denied Freschi leave to amend his complaint to add a

[Footnote continued on following page]

finding all defendants liable to Freschi, both directly and as aiders and abettors, for violations of Rule 10b-5; all defendants except Sherr liable to Freschi for state law fraud; and Bandler & Kass, Werner, Sylvor, and Sherr liable to him for legal malpractice. The jury awarded damages of $440,000 on the legal malpractice claim. For the Rule 10b-5 and state fraud violations, the jury awarded combined damages of $926,346.07, "plus all expenses incurred in both this action and actions before the tax courts plus interest due IRS on any deficiencies, including plaintiff's attorneys' fees." The jury further "suggested" that part of the damage award "be held in some type of escrow account" and awarded only if Freschi, who was challenging the IRS deficiency assessment, ultimately suffered the full tax losses he claimed. On a motion by the defendants, the trial judge rendered judgment non obstante veredicto on the legal malpractice count, and, disallowing that part of the award based on increased tax liability, offered Freschi remittitur of the remaining damage award from $926,346.07 to $266,500, the amount of his investment, plus pre-judgment interest of $126,681.75. Freschi accepted the remittitur offer. Defendants filed a timely appeal to this court, and Freschi filed a timely cross-appeal.[4]

[Footnote continued from previous page]

cause of action under the Organized Crime Control Act of 1970 ("RICO"), Pub L. 91-457, 84 Stat. 941, 18 U.S.C. § 1961 *et seq.* *Freschi v. Grand Coal Venture*, 583 F. Supp. 780, 787-88 (S.D.N.Y. 1984). At the close of the evidence and before submission of the case to the jury, the court directed a verdict for defendants on a breach of contract cause of action.

[4] Because Freschi accepted the trial court's offer of remittitur, he conditioned his cross-appeal on this court's altering the remittitur offer.

II.

A.

The first issue we must address is whether the findings of liability against all appellants on the 10b-5 count, and against all appellants except Sherr on the state law fraud count, can stand. Appellants argue that Freschi's claim against them on these counts was barred by California's three-year statute of limitations for fraud when Freschi filed the action in July 1981.

Freschi and the appellants agree that the three-year California statute of limitations for fraud governs both the fraud and the Rule 10b-5 causes of action.[5] They also agree that the causes of action accrued when Freschi discovered the alleged violations or should, upon reasonable inquiry, have discovered them.[6] *Arneil* v. *Ramsey*, 550 F.2d 774, 780 (2d Cir. 1977); *Korn* v. *Merrill*, 403 F. Supp. 377, 387 (S.D.N.Y. 1975), *aff'd*, 538 F.2d 310 (2d Cir. 1976).[7] They disagree, however, on the crucial issue

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[5] Rule 10b-5, like many federal causes of action, has no express statute of limitations. Accordingly, the federal courts adopt the most analogous state statute of limitations. Both parties agreed that the statute of limitations for fraud was the most analogous limitations statute, and further agreed that the law of the forum state, New York, would apply the limitations statute of California, the state of plaintiff Freschi's residence.

[6] While the federal courts adopt the analogous state staute of limitations in 10b-5 actions, the time at which the plaintiff's cause of action accrues is a question of federal law. *See, e.g., Phillips* v. *Levie*, 593 F.2d 459, 462 (2d Cir. 1979); *Arneil* v. *Ramsey*, 550 F.2d 774, 780 (2d Cir. 1977).

[7] A long series of cases establishes the need for due diligence on the part of a plaintiff in order to toll a statute of limitations for fraud. *See, e.g., Bailey* v. *Glover*, 88 U.S. (21 Wall.) 342, 348-49 (1874); *Robertson* v. *Seidman & Seidman*, 609 F.2d 583, 585 (2d Cir. 1979); *Phillips* v. *Levie*, 593 F.2d 459, 462 (2d Cir. 1979); *Berry Petroleum Co.* v. *Adams & Peck*, 518 F.2d 402, 410 (2d Cir. 1975).

of when Freschi should have discovered, upon reasonable inquiry, that he was the victim of a fraud. Appellants assert that he should have become aware of this fact on March 31, 1978, when he received the Grand Coal Venture offering memorandum which, they allege, stated terms materially different from those which he had thought governed his investment. If this claim is accepted, the finding of liability must be reversed, as Freschi's time for bringing suit would have expired over three months before he filed suit in July 1981.

The question was submitted by the trial court as a question of fact to the jury, which returned a finding that the three-year statute of limitations did not bar the suit. Appellants do not contend that the trial court erred by submitting the question to the jury as one of fact; we must review this question as one of fact, and can reverse only if we conclude that the jury's finding was not supported by any substantial evidence.

We conclude that there was substantial evidence to support this jury finding, and therefore we affirm it. We have already detailed the rather painstaking investigation Freschi undertook on receiving the offering memorandum. While it is possible that some investors might have undertaken an even more through investigation, there was substantial evidence for the jury to find that this investigation satisfied the requirement of due diligence, and therefore to find that the statute of limitations did not bar the claim.

We note that the trial court's charge to the jury with regard to the statute of limitations, while correct in most particulars, placed the burden of proving that Freschi failed to exercise diligence on the defendants. The burden

ought to have been on Freschi as plaintiff to prove his diligence as the prerequisite to allowing equitable tolling of the limitations statute. *See, e.g., City of Detroit* v. *Grinnell Corp.*, 495 F.2d 448, 461 (2d Cir. 1974); *Long* v. *Abbott Mortgage Corp.*, 459 F. Supp. 108, 116 (D. Conn. 1978). Defendants, however, did not object to this aspect of the instructions at trial, and have not, in fact, raised it as an issue on appeal. We are not convinced that the trial judge's instruction in this regard was such plain error as to warrant reversal in the absence of an objection, timely or otherwise, by the parties arguably harmed [1] by the instruction. *See* Fed. R. Civ. P. 51.

B.

Having concluded that Freschi's suit was not barred by the applicable statute of limitations, we now proceed to consider whether defendants' conduct contained the elements of common law fraud and of Rule 10b-5 violations. In doing so, we first consider the elements of each cause of action, and then consider separately whether each party was properly found liable.

SEC Rule 10b-5, 17 C.F.R. § 240.10b-5, states:

> § 240.10b-5 Employment of manipulative and deceptive devices.
>
> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality

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[1] We say "arguably harmed" because we are not persuaded that the instruction constituted anything more than harmless error, given the evidence for the exercise of due diligence on Freschi's part. Because we base our decision on this point on the lack of an objection, it is unnecessary, however, for us to decide whether the instruction did constitute harmless error, and we refrain from doing so.

of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

Thus a 10b-5 violation has two essential elements, the use of the mail, an instrumentality of interstate commerce, or a securities exchange facility, and a fraudulent scheme or untrue or misleading statement. Case law has further clarified the prerequisites for a 10b-5 action by a private party, and has established that the plaintiff must have been the purchaser or seller of a security, that the deceptive conduct must have occurred in connection with the purchase or sale of the security, and that the defendant or defendants must have acted with scienter. *See generally* T. Hazen, The Law of Securities Regulation § 13.2 (1985).

With respect to appellant Werner, the evidence of a 10b-5 violation is overwhelming. Werner repeatedly used the telephone, an instrumentality of interstate commerce, to induce Freschi to invest in Grand Coal Venture. In so doing, he misrepresented to Freschi that the prior Spruce Productions offering was withdrawn because of tax problems. This was a lie, and Werner knew it. The evidence

establishes that Werner withdrew the Spruce Productions offering because he was under a court order not to market it. It further establishes that the court order stemmed from activities by a client of Werner's in marketing a similar offering which had aroused the suspicion of the SEC.[2] Werner asserts that the misinformation he gave Freschi and the information he failed to give Freschi were not material. This contention is frivolous. Any reasonable investor would be interested in knowing that the SEC was concerned about possible fraud in connection with a securities offering which the offeror himself described as "basically similar" to the one under consideration for investment. Indeed, if Werner did not consider the fact important, it is difficult to understand why he found it necessary to lie to Freschi about it. Werner not only gave Freschi a false reason for the change in the leases being offered, but failed to tell Freschi that the source of the new leases was an individual the SEC suspected of fraud. We cannot find that it was unreasonable for the jury to consider these misstatements and omissions material; in fact, we are inclined to think that it would have been unreasonable for the jury to have done otherwise.

Werner's argument that he acted without scienter is just as frivolous. Werner knew that the reasons he gave for the change in the offering were not true, and he knew about the court order which was the real reason for the

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[2] In *SEC* v. *American Bd. of Trade, Inc.*, 751 F.2d 529, 540-41 (2d Cir. 1984), we held that it was not improper for the defendant in that action to fail to disclose the existence of a preliminary injunction against it to potential investors. The circumstances of that case were very different, however; as we specifically noted, the preliminary injunction in that case was prompted, not by intentional misconduct, but by a bona fide disagreement between defendant and the SEC as to the interpretation of very technical regulations.

change: indeed, he had been personally served with a copy of it when he made the false and misleading statements to Freschi.

The only remaining issue with respect to Werner's 10b-5 liability, then, is whether Freschi relied on his statements and whether such reliance was reasonable. Freschi testified that he relied on Werner's statements in making the investment decisions on behalf of the trust, and the circumstances support his testimony. At the time of Freschi's December 15 conversation with Werner, he had decided to invest the trust's funds in Spruce Productions: the offering, however, had been withdrawn. Four days after the conversation, Freschi authorized his agent to investigate Bandler & Kass and, if satisfied, invest the trust's funds in the replacement offering, Grand Coal Venture. Even without Freschi's testimony, the conclusion that he relied on Werner's assurances in deciding to invest in Grand Coal Venture would be compelling.[10]

The jury was justified in concluding that Freschi's reliance on Werner's statements was reasonable. There was no particular reason for Freschi to suspect that the undertaking was a fraudulent one. No evidence has been presented indicating that Laird's transactions had achieved the sort of notoriety which would have put Freschi on notice that he was dealing with swindlers.

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[10] Appellants contend that the potential profitability of the venture was irrelevant to Freschi's investment decision, as the trust's only interest, they allege, was in finding a tax shelter. Apart from the fact that only bona fide investments are eligible for tax preferences, this argument is rebutted by Freschi's testimony that he was interested in finding an investment offering both tax advantages *and* a reasonable return. The fact that Freschi took steps, after receiving the offering memorandum, to verify that the leased lands did contain coal supports his assertion that he was concerned with the venture's potential for profit.

Appellants suggest that Freschi ought to have made an independent investigation into whether the leased property actually contained coal reserves. There is respected authority suggesting that such investigation by an investor in mining operations is not necessary. *See Securities & Exchange Comm'n* v. *Texas Gulf Sulphur Co.*, 401 F.2d 833, 862-63 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969) (considering the existence of a private cause of action for investors misled by company misrepresentations as to the presence of mineral reserves without any suggestion that investors should have made their own geological investigations).

Freschi, moreover, did undertake some independent efforts to verify the soundness of the offering, as noted above: he obtained legal and accounting advice and sent an agent to inspect the offices of Bandler & Kass to determine that it was a legitimate law firm. To assert that Freschi's efforts to verify the information he received were insufficient to make his reliance reasonable is tantamount to asserting that he should have suspected fraud from the start. As we have said, we see nothing to indicate that he should, and we do not think the jury was unreasonable in so viewing the case.

Sylvor and Sherr, law partners of Werner, were actively involved in the preparation of the Grand Coal Venture offering. Each was aware of the devious operations of Laird, and each knew of the T.R.O. against Laird and against themselves as Laird's attorneys. While the evidence against Sylvor and Sherr may not have been as overwhelming as that against Werner, it was not reversible error for the jury to find Rule 10b-5 liability on the basis of their conduct. *See Bloor* v. *Carro, Spanbock, Londin, Rodman & Fass*, 754 F.2d 57, 62 (2d Cir. 1985).

Bandler & Kass was actively involved in the Grand Coal Venture offering as well. Not only were three of the principals in the venture Bandler & Kass partners who utilized the firm's facilities to market their fraudulent scheme, but Freschi's checks investing funds in the venture were made out to "Bandler & Kass, Special Account," and accepted by the firm for payment to that account. Thus it was not error for the jury to find Bandler & Kass liable under Rule 10b-5. Similarly, the jury did not err in finding 10b-5 liability on the part of Ground Production Corporation, which marketed the Grand Coal Venture units.

Defendant-appellant Jack Mitnick was Venture Administrator for Grand Coal Venture. The record is absolutely devoid of any showing that he made any misrepresentations to Freschi, or knowingly assisted anyone else in doing so, before Freschi made the investment in December 1977. Since a misrepresentation is actionable under Rule 10b-5 only if it is made in the course of the purchase or sale of a security, Mitnick cannot be held liable for a 10b-5 violation. The judgment to the contrary must be reversed.[11]

Defendant-appellant Baker's role was essentially that of a middleman conveying the leases from Laird to Werner, Sylvor and Sherr. The record establishes that Baker supplied Laird with false geological reports and that the sponsors of the Spruce Productions offering made use of those reports in preparing their prospectus. Baker submitted reports, as president of a consulting firm called

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[11] Mitnick's conduct as Venture Administrator arguably violated his fiduciary duties to the investors. He was not held liable, however, under any such theory. As noted below, the jury properly held Mitnick liable for fraud.

Mineral Resources Development, giving Grand Coal Venture his opinion that the leased land contained large quantities of coal reserves. These opinions, of course, turned out to be erroneous. There is evidence, moreover, that Baker knew these representations to be false or acted with reckless disregard as to their truth. For example, his reports indicated that sub-bituminous coal was available on leased land in North Dakota, while it is a well-known fact in geological circles (as an expert witness testified) that there is no sub-bituminous coal in North Dakota. In addition, there were other misrepresentations in Baker's report. For example, he took advantage of the fact that one of his staff geologists had recently married, and therefore changed her name, to give the impression that her reports before and after the marriage represented the independent findings of two different geologists. The evidence also suggests that he overrepresented his own geological qualifications. All of these representations, moreover, were made to the parties marketing Grand Coal Venture prior to the time Freschi made his investment. Although the case as to Baker's liability is a closer one than that as to the other defendants, we think that there was enough evidence for the jury at least to have found Baker to be a knowing aider and abettor of the 10b-5 violations. Accordingly, we do not reverse the judgment as to Baker.

We now turn to the common law fraud count, on which the jury found all defendants except Sherr liable. The parties agree that the substantive law governing this count is that of New York. As we noted in *Mallis v. Bankers Trust Co.*, 615 F.2d 68 (2d Cir. 1980), *cert. denied*, 449 U.S. 1123 (1981), the elements of fraud in New York are representation of a material fact, falsity of that representation, scienter, reliance, and damages.

Id. at 80 (*citing JoAnn Homes* v. *Devorety*, 25 N.Y.2d 112, 119, 302 N.Y.S.2d 799, 803 (1969) and 24 N.Y. Jur., Fraud & Deceit § 14 at 47-48 (1962)). We have discussed all these points in connection with the 10b-5 claim, and it would be repetitious for us to engage in separate discussion here. Our prior discussion of why the jury's findings of 10b-5 liability as to Werner, Sylvor, Baker, Ground Production Corporation, and Bandler & Kass were proper makes it sufficiently clear why the jury was also justified in finding these parties liable for fraud. We further note that while we reversed the finding of 10b-5 liability as to Mitnick, on the ground that he did not make any misrepresentations prior to Freschi's investment, the record amply demonstrates that he committed fraud by his misrepresentations to Freschi in the course of his administration of the investment, by which he attempted to conceal the worthlessness of Freschi's investment from him. For example, Mitnick signed letters dated August 22, 1978 and March 31, 1979 making representations to participants about Grand Coal Venture's attempts to obtain substitute coal-producing properties. These were knowing false representations on which Freschi relied. He was harmed by these statements, in that they prevented him from taking action sooner to recover his money. Accordingly, we affirm the finding of liability as to Mitnick on the fraud count.

The final contention of appellants we must address with respect to the findings of liability is that the court committed reversible error by allowing plaintiff's counsel, in closing argument, to refer to Freschi's belief that his leases guaranteed him replacement properties, in spite of the fact that the court had ruled that Freschi could not reasonably have held such a belief. We fail to see how appellants could have been prejudiced by this argument

The heart of the fraud consisted of the misrepresentations concerning the substitution of Grand Coal Venture for Spruce Productions and the attendant cover-up as to the Laird connection and the temporary restraining order. The evidence as to these misrepresentations was overwhelming, and would have been no less so without counsel's argument on an extraneous issue.

We turn now to the question of damages. There is no question that the trust lost its entire investment, the amount of which was $266,500. Before we determine the amount of the trust's damages, however, we have to consider the effect of any tax consequences. First, we must consider whether the trust's damages must be reduced by any tax deduction obtained as a result of the loss, in light of the principles we recently announced in *Salcer*, 744 F.2d at 935. Second, we must consider whether Freschi is entitled, as he argues on cross-appeal, to damages as a result of any adverse tax consequences which he would have avoided if the Grand Coal Venture had been a legitimate tax shelter.

In *Salcer*, we said:

> . . . § 28a of the Exchange Act [15 U.S.C. § 78bb (a)] . . . limits plaintiffs to recovery of their actual net economic loss. . . . In applying § 28(a) we cannot ignore the substantial economic tax benefits bargained for and realized by plaintiffs.

Salcer, supra, at 941. In this case, the trust sustained losses of $266,500 as a result of its investment. Since IRS allowed the trust's beneficiary a $266,500 deduction from ordinary income as a result, however, and since this resulted in a tax savings of $188,682, the trust's actual loss was only $77,818. Application of *Salcer* requires that

this actual net loss constitute Freschi's recovery on behalf of the trust.

Freschi argues, on cross-appeal, that his damages should be increased to compensate the trust for tax savings it would have realized had the full deductions been allowed. The district court correctly held that a Rule 10b-5 plaintiff can be compensated only for actual damages, and that any award in compensation for hoped-for tax savings would be an impermissible award of damages arising from an expectation interest. *See, e.g., Levine* v. *Seilon, Inc.*, 439 F.2d 328, 334 (2d Cir. 1971); *Chasins* v. *Smith, Barney & Co., Inc.*, 438 F.2d 1167, 1173 (2d Cir. 1970). Similarly, the trial court noted that the interest and penalties IRS assessed against the senior Freschi were not a consequential damage; rather, they were simply compensation to IRS for the use of money IRS would have had if the senior Freschi had not wrongly withheld it. The interest and penalties were not, the trial court correctly observed, really a damage suffered by the senior Freschi at all, but a return by him of what would otherwise be a windfall resulting from his opportunity to use money to which he was not entitled.

III.

In conclusion, we AFFIRM the jury findings of 10b-5 violations on the part of Werner, Sylvor, Sherr, Baker, Bandler & Kass, and Ground Production Corporation, and the findings of common law fraud as to all the above except Sherr. We REVERSE the jury's finding of liability as to Mitnick on the 10b-5 count, but AFFIRM the judgment against him on the fraud count. We remand, with instructions that the order of remittitur be amended,

so that Freschi is offered a choice between damages of $77,818 (plus pre-judgment interest) [12] and a new trial.

Freschi's cross-appeal asks that, in the event the remittitur is altered, the trial court be instructed to allow him to proceed on legal malpractice, breach of contract, and RICO (18 U.S.C. § 1961 *et seq.*) counts in the event he should elect a new trial. Because we believe that the trial court was correct in granting judgment non obstante veredicto on the first of these counts, directing a verdict for defendants on the second, and denying Freschi leave to amend his complaint to add the third, we deny this request.

The judgment of the district court is affirmed in part and reversed in part. This case is remanded for further proceedings not inconsistent with this opinion.[13]

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[12] In awarding pre-judgment interest only on $77,818, we are assuming that IRS, in charging Freschi interest on the taxes it determined he owed, did not charge interest on tax payments withheld as a result of the $266,500 deduction, which was ultimately allowed. If this assumption is erroneous and IRS did at some point charge Freschi interest on taxes withheld as a result of the $266,500 deduction, pre-judgment interest should be appropriately increased.

[13] Because the attorney-defendants in this case (Werner, Sylvor, Sherr, and Mitnick) committed actions raising serious questions as to their professional integrity, and because it is not clear from the record exactly what disciplinary action has been taken against them, we instruct the clerk to send copies of this opinion to the appropriate professional conduct review committees.

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No. 84-1447 (H)

In the Supreme Court of the United States

OCTOBER TERM, 1985

WILLIAM Z. SALCER, ET AL., PETITIONERS

v.

ENVICON EQUITIES CORP., ET AL.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE UNITED STATES AS AMICUS CURIAE

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QUESTION PRESENTED

Whether defendants in a federal securities fraud action are entitled to reduce the amount of recoverable damages by tax benefits allegedly obtained by plaintiffs on account of their investment.

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ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE UNITED STATES AS AMICUS CURIAE

This brief is filed in response to the Court's order inviting the Solicitor General to express the views of the United States.

STATEMENT

1. Petitioners are purchasers of interests in a real estate limited partnership, marketed as a tax shelter, to construct, own, and operate a multifamily rental housing project outside Houston, Texas (Pet. App. 3a). Respondents are the general partners of the project and their affiliates, lawyers and accountants (*ibid.*). Petitioners purchased their limited partnership interests in 1977-1978. In 1981, petitioners were forced to sell their interests to one of the respondents at a substantial loss (*id.* at 3a-4a).

In August 1982, petitioners brought this action in the United States District Court for the Southern District of New York, alleging violations of the antifraud provisions of Section 10(b) of the Securities Exchange Act of

1934 (the Act), 15 U.S.C. 78j(b), and SEC Rule 10b-5, 17 C.F.R. 240.10b-5. Petitioners contended that respondents had defrauded them by failing to disclose the City of Houston's intention to annex the property. They claimed that respondents should have anticipated at the time of the offering that annexation would result in more stringent building code requirements, causing significant delays, increased costs, and loss of financing. Petitioners sought rescissionary damages of $47,500 per partnership unit, a figure that represented the difference between the price petitioners paid ($77,500 per unit) and the amount they received in the forced sale ($30,000 per unit). Pet. App. 4a. Petitioners also requested prejudgment interest.

Respondents in their answer to the complaint asserted, by way of affirmative defense, that petitioners had suffered no cognizable damages because they had realized during their 1977-1981 tax years tax benefits stemming from their limited partnership investments in excess of their claimed per-unit loss of $47,500 (Pet. App. 4a). Respondents based this assertion on the limited partnership offering materials and on the assumption that each petitioner was taxed at a marginal federal income tax rate of at least 50% during the relevant years (*id.* at 4a-5a, 32a-35a). The calculation of petitioners' alleged tax benefits was made by respondents based on their own estimates (Appellants' C.A. Br. 40). There has as yet been no discovery into the actual tax consequences of the investment for petitioners during 1977-1981 (Pet. App. 5a).[1]

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[1] For purposes of the district court's ruling on their motion to strike, petitioners stipulated that respondents had correctly determined that the tax benefits they had claimed exceeded their net investment in the partnership (Pet. App. 34a; C.A. App. 205a-206a; Appellees' C.A. Br. 12).

2. The district court granted petitioners' motion to strike the affirmative defense (Pet. App. 19a-22a, 25a-31a). The district court reasoned that petitioners' investment consisted of two components: the opportunity to obtain tax benefits and the investment in a capital resource (*id.* at 26a-27a). Because the allegations of fraud pertained only to the capital investment component, the district court held that petitioners' recovery should not be reduced by their return on the tax benefit aspect of their investment (*id.* at 28a-29a). The district court certified its decision for immediate appeal under 28 U.S.C. 1292(b).

The court of appeals reversed and remanded (Pet. App. 1a-18a). The court of appeals suggested that resolution of the tax offset issue was inappropriate on a motion to strike because "the law * * * is confused and unsettled * * * [and] further facts must be obtained" (*id.*at 8a), but it went on in any event to address the merits of the defense. Relying on the "actual damages" limitation of Section 28(a) of the Act, 15 U.S.C. 78bb(a), the court reasoned that petitioners' tax savings must be subtracted from their loss in calculating damages because those savings represent tangible economic benefits to them (Pet. App. 8a-10a). It was irrelevant in the court's view whether the investment could be separated into distinct tax and capital components: "[t]o the extent that [petitioners] invested in a tax shelter, all benefits they received from their investment, including tax benefits, would have to be deducted in calculating the rescissionary damages, if any, to which they would be entitled" (*id.* at 11a). The court rejected arguments that its tax offset rule improperly made the government the banker for fraudulent activity, conflicted with the collateral source doctrine, treated tax benefits that might ultimately prove illusory as real, and reduced the incentives for private actions under the antifraud provisions of the securities laws (*id.* at 11a-17a).

DISCUSSION

The court of appeals has erroneously decided a recurring issue of substantial importance to both the government and private parties, and its decision conflicts with decisions of another court of appeals. Review by this Court is therefore warranted.

1. As the court of appeals recognized (Pet. App. 8a), the law on the question presented is "confused and unsettled." The decision below conflicts with *Western Federal Corp.* v. *Erickson*, 739 F.2d 1439 (9th Cir. 1984), and *Burgess* v. *Premier Corp.*, 727 F.2d 826 (9th Cir. 1984). In *Burgess*, the plaintiffs, like petitioners here, sought rescissionary damages under the federal securities laws for fraud in connection with a tax shelter investment (*id.* at 830). The court held that "deduction of the tax benefits from damages is inappropriate" in these circumstances (*id.* at 837-838). The court reasoned that allowing defendants to offset plaintiffs' tax benefits "would place an unfair burden on taxpayers generally" by "leav[ing] the government [to] bear[ ] the cost of defendants' fraud" (*id.* at 838). Plaintiffs would not receive a double recovery, in the court's view, "because under the tax benefit rule, their prior tax benefits will be disallowed" (*ibid.*). In *Western Federal Corp.*, the court followed its decision in *Burgess* and "refus[ed] to reduce the judgment by the amount of tax benefits [plaintiffs] realized from their investment" (739 F.2d at 1444).

Two courts of appeals, by contrast, have held that tax benefits must be deducted from plaintiffs' damages in suits under the federal securities laws. In addition to its decision below, in which the court of appeals rejected the Ninth Circuit's reasoning in *Burgess* (Pet. App. 12a, 15a), the Second Circuit recently held in *Freschi* v. *Grand Coal Venture*, 767 F.2d 1041 (1985), petition for cert. pending, No. 85-377, that tax benefits must be

deducted where the plaintiff seeks out-of-pocket damages for securities fraud. In *Freschi*, the court of appeals concluded that its decision in the instant case was controlling, see 767 F.2d at 1043, 1051.[2] Similarly, the Eighth Circuit has recently held that tax benefits must be deducted from the damages recoverable by plaintiffs who have been defrauded in connection with the purchase of their tax shelter investment, noting that its decision is substantially in accord with the decision below. *Austin* v. *Loftsgaarden*, 768 F.2d 949, 952 (1985) (en banc), petition for cert. pending *sub nom. Randall* v. *Loftsgaarden*, No. 85-519.[3]

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[2] In opposing certiorari here, respondents principally contend (Br. in Opp. 5-10) that the decision below should not be reviewed because it arises on a motion to strike under Fed. R. Civ. P. 12(f). It is clear from *Freschi*, however, that the Second Circuit treats the decision below as having conclusively determined the substantive issue presented, *i.e.*, whether tax benefits should be offset in tax shelter securities fraud cases. Moreover, the relevant facts are not in dispute—the parties argued the tax offset issue on stipulated facts (see Pet. App. 34a)—and petitioners have made it clear that they will suffer a dismissal if the tax offset rule is applied (*id.* at 32a-33a). Under these circumstances, the case is ripe for review by this Court.

[3] Respondents (Br. in Opp. 12) and the courts of appeals here (Pet. App. 17a) and in *Loftsgaarden* (768 F.2d at 952 n.4, 955 n.11) erroneously distinguish *Burgess* v. *Premier Corp.*, *supra*, as a case of actual rescission rather than one involving rescissionary damages. In fact, the plaintiffs in *Burgess*, like petitioners here, had already sold their investment, and they sought, as petitioners seek here, rescissionary damages equal to the amount of their investment less what they received in the sale. See 727 F.2d at 830, 837. In any event, the distinction between "actual rescission" and "rescissionary damages" is wholly irrelevant to resolution of the legal issue presented.

2. a. The court of appeals' decision rests on an unduly narrow view of the concept of "actual damages" under Section 28(a) of the Act.[4] Consistent with the remedial and compensatory purposes of private actions under the federal securities laws (see, *e.g.*, *Herman & MacLean* v. *Huddleston*, 459 U.S. 375, 386-387 (1983)), Section 28(a) permits recovery under traditional principles for determining compensatory damages. The purpose of Section 28(a)'s limitation of a plaintiff's recovery to "actual damages" is simply to prevent duplicative recoveries by persons asserting both state and federal claims arising out of the same course of conduct, and to prohibit the award of punitive damages and damages for non-economic losses such as pain and suffering. See, *e.g.*, *Osofsky* v. *Zipf*, 645 F.2d 107, 111 (2d Cir. 1981); *deHass* v. *Empire Petroleum Co.*, 435 F.2d 1223, 1230 (10th Cir. 1970).

In calculating the amount of damages under Section 28(a), courts must be careful to avoid unjustly enriching defendants. The Act does not prohibit an award based on the defendant's profit rather than the plaintiff's loss. To the contrary, adopting a measure of damages that will prevent defendants from retaining their ill-gotten gains is fully consistent with the purposes of the securities laws. See, *e.g.*, *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128, 155 (1972); *Hackbart* v. *Holmes*, 675 F.2d 1114, 1122 (10th Cir. 1982). While we disagree with the court of appeals that plaintiffs would receive "an undeserved windfall" (Pet. App. 13a) absent the offset of tax benefits—because, as we explain

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[4] Section 28(a), 15 U.S.C. 78bb(a), provides in pertinent part:

> [N]o person permitted to maintain a suit under the provisions of this chapter shall recover, through satisfaction of judgment in one or more actions, a total amount in excess of his actual damages on account of the act complained of. * * *

below, any apparent windfall will often prove wholly illusory in view of the tax consequences of the damage award—it is in any event clear that Section 28(a) "does not foreclose a windfall recovery based on the defendant's benefit rather than the plaintiff's loss." L. Loss, *Fundamentals of Securities Regulation* 1134 (1983).

Nor is there any unfairness in a measure of damages based on the defendant's benefit rather than the plaintiff's loss. In the first place, as between the innocent plaintiff and the defendant who defrauded him, the former is quite plainly more equitably situated to retain in the first instance any tax savings obtained as a result of his investment. If there is to be a windfall, surely it should rest in these circumstances with the plaintiff and not with the defendant. Indeed, any net tax savings retained by a plaintiff may compensate him for the loss of the use of the funds fraudulently obtained by the defendant, much as would an award of prejudgment interest (see *Burgess*, 727 F.2d at 838; SEC C.A. Br. 15-16). Finally, measuring damages without offsetting tax benefits is consistent with the long-recognized "collateral source" rule, which provides that "benefits conferred on the injured party from other sources are not credited against the tortfeasor's liability." Restatement (Second) of Torts § 920A(2) (1979).[5]

b. In addition to erroneously interpreting the rules governing damages in securities cases, the court of appeals' decision is wrong as a matter of tax law. The court concluded (Pet. App. 10a) that the tax benefits

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[5] The court of appeals erroneously distinguished the collateral source rule on the ground that the tax benefits "emanate directly from the tax shelter * * * provided by [respondents]" (Pet. App. 13a). The tax benefits were in fact provided, however, by the Internal Revenue Code, not by respondents. In this respect, they constitute "benefits conferred * * * from other sources" within the meaning of Section 920A(2) of the Restatement.

claimed by petitioners on their 1977-1981 tax returns "represent[ed] an important tangible economic advantage" stemming from their limited partnership investments. Unless petitioners' damage recovery were diminished to reflect that fact, the court reasoned, the result "would be to confer an undeserved windfall upon [them]" (*id.* at 13a-14a). In thus reasoning, however, the court completely ignored the tax consequences of the damage recovery itself (*id.* at 14a). Depending on the facts involved, the tax consequences of a damage recovery *undiminished by tax benefits* would largely if not totally offset the tax benefits previously claimed. In short, because the Internal Revenue Code incorporates mechanisms for preventing "undeserved windfalls" to taxpayers in such circumstances, the court of appeals' "tax offset" theory is unnecessary and unjustifiable. Compare *Hanover Shoe, Inc.* v. *United Shoe Mach. Corp.*, 392 U.S. 481, 502-503 (1968) (award for lost profits based on pre-tax earnings where award is taxable), with *Norfolk & W. Ry.* v. *Liepelt*, 444 U.S. 490 (1980) (award for lost income based on after-tax earnings where award is not taxable).

The anticipated "tax benefits" stemming from a real estate tax shelter principally include losses that pass through from the partnership to the partners and become available as deductions against otherwise taxable income on their individual returns. Such losses also serve to reduce, dollar for dollar, the partner's cost, or tax "basis," of his investment. In addition to such tax shelter benefits, as in any investment that has proved to be poor or fraudulent, a partner may have claimed further tax deductions on disposing of his interest. For example, if he has been forced to sell his interest at a loss, as were petitioners here, he may have deducted that loss as a capital loss. See I.R.C. §§ 165, 741. Alternatively, a defrauded partner, while nominally main-

taining his investment, may have concluded that it has become worthless and deducted it, *e.g.*, as a theft loss. See I.R.C. § 165(c)(3), (e); see generally *Freschi* v. *Grand Coal Venture, supra.*

If the taxpayer subsequently obtains a recovery in a securities fraud suit, the effect of that recovery under the Internal Revenue Code may be to eliminate or offset, in whole or in part, the "tax benefits" described above. The precise manner in which this offset will be accomplished depends on a host of variables—how much time has elapsed since the taxpayer claimed his deductions, whether his tax returns are being audited by the IRS, what steps he has previously taken with respect to his investment, and what kind of recovery he obtains in the securities action. Under any scenario, however, the tax laws will require the partner to settle his accounts with the IRS—once all the facts surrounding his unhappy investment are finally determined—so as to eliminate the possibility of his garnering any "undeserved windfall."

If the tax years in which the deductions were claimed have not been closed by the statute of limitations, but remain subject to audit,[6] the IRS may disallow some or all of those deductions. For example, should the tax-

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[6] Generally speaking, a tax year "closes" three years after the return for that year is filed (I.R.C. § 6501(a)). However, a taxpayer and the IRS by agreement may extend the statute of limitations (*id.* § 6501(c)(4)), and this course is often followed in complex audits. In this case, petitioners claimed the relevant deductions on their tax returns for 1977-1981. At the time they commenced this lawsuit—August 1982—their 1979-1981 tax years would have remained open under the general three-year statute of limitations; the record does not reveal whether extension agreements were executed for 1977 and 1978. In certain situations, the IRS has more than three years in which to assess tax deficiencies. See I.R.C. § 6501(c) and (e). The record similarly does not reveal whether any of these exceptions might apply here.

payer win rescission of his investment contract, the IRS, depending on the circumstances, might disallow certain deductions predicated on his ownership of it. Alternatively, if the taxpayer has written off his investment entirely, that loss deduction may be disallowed on audit, depending, *e.g.*, on the type of loss claimed (loss on a sale, theft loss, or worthless securities), the time when the fraud was discovered, and whether the taxpayer was pursuing a claim for reimbursement with "a reasonable prospect of recovery" during the tax year in question. See Treas. Reg. §§ 1.165-1(d).

On the other hand, if the partner's earlier tax years are closed, other tax principles may apply to require adjustments that eliminate the benefit of the deductions he previously claimed. For example, if the defrauded partner wins relief in the nature of rescission, some if not all of his recovery could be taxed to him as ordinary income under the "tax-benefit rule." As this Court recently observed, the tax benefit rule operates to "cancel out an earlier deduction" when a subsequent event is "fundamentally inconsistent with the premise on which the deduction was initially based." *Hillsboro Nat'l Bank* v. *Commissioner*, 460 U.S. 370, 383 (1983) (original quotation marks and footnote omitted). Alternatively, if the defrauded partner wins out-of-pocket damages (see note 8, *infra*), the damage award generally will serve to reduce the basis of his partnership interest. If he has already disposed of that interest, or if he has reduced his basis to zero by previously-claimed deductions, the entire damage award will represent taxable income when received. Such an award might be taxed, in whole or in part, as ordinary income under the tax-benefit rule, or under the Code's various "recapture" provisions. *E.g.*, I.R.C. §§ 47 (investment tax credits), 1250 (depreciation). Any portion not so taxed would be taxed at capital gains rates. Compare *Raytheon Produc-*

tion Corp. v. *Commissioner*, 144 F.2d 110 (1st Cir.), cert. denied, 323 U.S. 779 (1944), with *Unvert* v. *Commissioner*, 656 F.2d 483 (9th Cir. 1981), cert. denied, 456 U.S. 961 (1982).

The above discussion is not intended as an exhaustive catalogue of tax consequences, which can be extremely complex and take years to resolve. The point is simply that the Internal Revenue Code, left to its own devices, will prevent the "undeserved windfall" about which the court of appeals was concerned. If a defendant has defrauded a plaintiff, the damages should be measured by the plaintiff's loss *on his investment*. The tax ramifications of the award are a matter between the plaintiff and the IRS. Once the securities lawsuit is over, and the relevant facts are finally determined, those ramifications will be sorted out, on a case-by-case basis, under well-established tax principles.

3. In insisting upon an immediate offset of previously-claimed tax benefits, the court of appeals has opted for an impractical and inequitable result that will have a significant adverse impact on administration of the federal securities and tax laws. Just last Term, the Court emphasized once again that "private actions provide 'a most effective weapon in the enforcement' of the securities laws and are 'a necessary supplement to Commission action.' " *Bateman Eichler, Hill Richards, Inc.* v. *Berner*, No. 84-679 (June 11, 1985), slip op. 10 (quoting *J.I. Case Co.* v. *Borak*, 377 U.S. 426, 432 (1964)). By improperly reducing—and often, as here, eliminating entirely—the damages recoverable by plaintiffs who have been defrauded in connection with tax shelter schemes, the rule applied by the court of appeals will necessarily lessen the incentives for promoters to comply with the securities laws and will permit those persons who have violated the laws to retain the fruits of their illegal activities.

From a tax perspective, the decision below is equally troubling. It will often happen, at the commencement of a securities action, that the tax returns on which the plaintiff claimed his deductions will be under audit by the IRS. In such circumstances, obviously, the plaintiff's "tax benefits" will be wholly speculative, and any effort to offset the damage award thereby will lapse into a tailspin of circular reasoning.[7] Most significantly, the court of appeals' tax-offset rule "make[s] the government the banker for fraudulent tax shelter activity" (*Burgess*, 727 F.2d at 838). By requiring a lower damage award—or none at all—for the plaintiff, the court of appeals' approach in turn will limit any possible recovery by the IRS when the award's tax consequences are taken into account. There is no reason in equity why a defendant's liability for his fraud should thus be diminished at the expense of his victims, or at the expense of taxpayers generally.

4. The instant case would provide an appropriate vehicle for the Court to address the question presented. In our view, it would also be appropriate for the Court to

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[7] It is no answer to suggest, as the Eighth Circuit has done, that "[e]vidence of the audit and expert opinions as to its likely result" should be introduced at trial, with "[t]he jury [being] entitled to determine whether and to what extent there would be a disallowance of deductions." *Austin* v. *Loftsgaarden*, 675 F.2d 168, 183 (1982), adhered to, *Austin* v. *Loftsgaarden*, 768 F.2d 949 (1985), petition for cert. pending *sub nom. Randall* v. *Loftsgaarden*, No. 85-519. The prospect of juries guessing about the outcome of complicated tax audits, often involving numerous taxpayers and difficult legal as well as factual questions, is altogether impractical. Nor is it any answer to demand, as the court of appeals did here, that the IRS speed up its audit procedures "rather than attempt to place the issue in limbo indefinitely" (Pet. App. 15a-16a). The difficulties attending audits of tax shelters, which may have thousands of partners or other investors spread across the country, are formidable, and recently prompted detailed remedial legislation by Congress. See Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, Tit. IV, § 402(a), 96 Stat. 648-669 (enacting I.R.C. §§ 6221-6232).

give plenary consideration to *Randall* v. *Loftsgaarden*, No. 85-519. In *Loftsgaarden*, plaintiffs sought damages under Section 12(2) of the Securities Act of 1933, 15 U.S.C. 77*l*(2), as well as under Section 10(b) of the Securities Exchange Act of 1934, the provision at issue here (see 768 F.2d at 952; 675 F.2d at 172, 180-184). While in our view the tax-offset rule is erroneous under either section, Section 12(2)'s damages provision—mandating recovery of "the consideration paid for [the] security * * * less the amount of any income received"—is worded differently from the "actual damages" limitation applicable to actions under Section 10(b). See page 6 & note 4, *supra*. Moreover, in *Loftsgaarden* the court of appeals acknowledged the relevance of the tax consequences of the judgment, but it set forth arbitrary rules for determining precisely how to measure the extent of tax benefits that must be offset (768 F.2d at 957-961). This issue was not addressed in the instant case because the court did not consider the tax consequences of any judgment material and the parties had stipulated that the tax benefits would exceed damages recoverable under a tax-offset regime (see note 1, *supra*). Accordingly, we believe that the Court would be able to consider more fully the complex issues presented in securities actions involving tax shelters if certiorari were granted in *Loftsgaarden*.[8]

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[8] The petition in *Freschi* v. *Grand Coal Venture*, No. 85-377, presents the question of the propriety of the tax-offset rule in the context of out-of-pocket damages (which are based on the difference between the price paid for a security and its actual value at the time of the purchase) rather than, as here and in *Loftsgaarden*, in the context of rescissionary damages (which "seek [ ] to restore the parties to the status quo ante the sale," *Garnatz* v. *Stifel, Nicolaus & Co.*, 559 F.2d 1357, 1361 (8th Cir. 1977), cert. denied, 435 U.S. 951 (1978)). In our view, the tax-offset rule is incorrect under either measure of damages. The court of appeals in *Freschi*

CONCLUSION

The petition for a writ of certiorari should be granted.
Respectfully submitted.

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also erroneously extended the tax-offset rule beyond the benefits provided by a tax shelter to tax deductions claimed by investors for losses suffered on routine disposition of investment assets. That reasoning obviously would extend the offset rule well beyond the tax-shelter context to computation of damage awards in all securities transactions. Should the Court wish to address these issues directly, it would be appropriate to grant the petition in *Freschi*, as well as granting the petition in *Loftsgaarden*.

We are providing copies of this brief to counsel in *Freschi* and *Loftsgaarden*.

No. 84-1447

(5)

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1985

WILLIAM Z. SALCER, *et al.*,

Petitioners,

vs.

ENVICON EQUITIES CORP., *et al.*,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

RESPONDENTS' JOINT BRIEF IN RESPONSE TO THE BRIEF FOR THE UNITED STATES AS AMICUS CURIAE

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No. 84-1447

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FOR THE SECOND CIRCUIT

RESPONDENTS' JOINT BRIEF IN RESPONSE TO THE BRIEF FOR THE UNITED STATES AS AMICUS CURIAE

Respondents Envicon Equities Corp., Envicon Development Corp., Envitex Realty Corp., Venture Development Group, Inc., U.S. Southwest Associates, Turning Block Associates, Feit & Ahrens, William B. Bush, Jr., John W. Galston, Erving Wolf, Harry W. Burrow and Blonder, Seymour & Shapss jointly submit this brief in response to the brief for the United States as *amicus curiae* (the "Government's brief") and in opposition to the petition for a writ of *certiorari* seeking review of the decision of the United States Court of Appeals for the Second Circuit in *Salcer v. Envicon Equities Corp.*, 744 F.2d 935 (1984) ("*Salcer*").

ARGUMENT

The Government's brief, while characterizing the issue presented herein as a "recurring issue of substantial importance to both the government and private parties" (Gov. Br. 4), does little more than reiterate the arguments that were presented to the Second Circuit below (and to the Eighth Circuit sitting *en banc* in *Austin v. Loftsgaarden*, 768 F.2d 949 (8th Cir. 1985) (*en banc*), *pet. for cert. pending sub nom. Randall v. Loftsgaarden*, No. 85-519) ("*Loftsgaarden*") by the SEC and the Tax Division of the Justice Department, as *amici curiae*. Those arguments were incorrect when asserted below, and reiteration here does not make them any more persuasive. Each of those arguments was fully considered by the Second Circuit and, in a well-reasoned decision, was properly rejected.

More important, however, the Government's brief virtually ignores the question put to it by the Court, that is, whether the issue presented by the *Salcer* case is appropriate for consideration by the Court. In the view of respondents, such a review is not warranted. There is no conflict among the circuits (indeed, as shown in Point II, only two of the circuits have considered the precise issue), and only now are the lower courts beginning to explore the manifold fact patterns in which the issue may arise, thus making a review by the Court at this time premature.

POINT I

THE ISSUE PRESENTED IS NOT OF SUBSTANTIAL IMPORTANCE TO THE GOVERNMENT

In asserting that the issue presented here is of "substantial importance" to it, the Government argues that the decision below will destroy the incentives for private enforcement of the securities laws and will have an adverse effect upon the United States Treasury. Both of these arguments are meritless.

First, the incentives for private enforcement of the securities laws operate by encouraging those who have actually been

damaged to seek compensation. This policy of compensation for economic injury has been enacted into law in Section 28(a) of the Securities Exchange Act, which limits recovery of private plaintiffs in actions under the Act to their "actual damages." 15 U.S.C. §78bb(a). *See Osofsky v. Zipf*, 645 F.2d 107, 111 (2d Cir. 1981). The Government offers no principled reason for ignoring the statutory standard requiring "actual damages" and fails to explain why sufficient incentives for private enforcement of the securities laws are not established by providing full redress to investors who have suffered some real economic injury. In addition, the Government ignores the substantial and unjustifiable cost to society and the judiciary in burdening the federal courts with suits by those who have not suffered any real economic injury.

Second, the adverse effect on the Treasury claimed by the Government results not from the decision below but from the tax benefits awarded in accordance with the conscious design of Congress as reflected in the Internal Revenue Code. In providing substantial tax incentives, Congress sought to encourage real estate development to achieve various public policy goals, such as the creation of jobs and the expansion of the housing market and the local tax base. Thus, as the Second Circuit correctly recognized, when the Greenspoint Project involved in the present case was built, the public was benefited and the Government got exactly what it bargained for.[1] (App. 12a)

Since the Government has failed to offer a persuasive explanation of the importance to it of this case, this Court should not heed the Government's call for review. Accordingly, the petition for a writ of *certiorari* in *Salcer* should be denied.

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[1] The Eighth Circuit *en banc* in *Loftsgaarden* agreed completely with the Second Circuit on this point. 768 F.2d at 956.

POINT II

THE GOVERNMENT INCORRECTLY ASSERTS A CONFLICT AMONG THE CIRCUITS

The Government's assertion that a conflict exists among the circuits (Gov. Br. 4-5) totally ignores the critical distinction between actual rescission and rescissionary damages.[2]

Actual rescission is a remedy that entirely undoes the legal effect of a transaction and restores the parties to their status prior to the transaction. Tax shelter investors seeking an award of actual rescission would be required to reconvey their partnership interests to the promoters and would receive back their original purchase price (less amounts received in the course of their partnership participation).

In sharp contrast, the remedy of rescissionary damages is available only if actual rescission has been made impossible by the sale to third parties of their partnership interests. *See* 5C A. Jacobs, *Litigation and Practice under Rule 10b-5* §260.03(c)(vi)(A) (2d ed. 1984). Rescissionary damages are measured by the amount of the original investment less the value of all benefits received by plaintiffs as a result of their investment. *See* Jacobs, *The Measure of Damages in Rule 10b-5 Cases*, 65 Geo. L.J. 1093, 1159-60 (1977).

As a matter of tax law, a judicial declaration of actual rescission might necessitate the filing of amended returns by the investors. While this is far from certain, *see Holbrook v. Commissioner*, 34 TCM 1283 (CCH) (1975), the Internal Revenue Service might contend that an order declaring the rescission of tax shelter investments would require a recomputation of prior "open"

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[2] The Government's assertion (Gov. Br. 5n.3), for which it cites no authority, that there is no legal significance to this distinction is mere *ipse dixit*.

years'[3] tax returns reflecting items attributable to the rescinded investment and payment of all of the taxes (plus interest) which would have been payable if the taxpayer had never invested in the venture.

In this case, in which rescissionary damages are claimed, if such damages were awarded, the investors would *not* need to file amended returns undoing all of the tax benefits they have heretofore received. At worst, they would merely have to declare their recovery as ordinary income in the year of receipt.[4] *See* 1 J. Mertens, *Law of Federal Income Taxation* §7.34, ch. 7, at 115 (1981).

The Government, without any analysis or authority (Gov. Br. 5n.3), cavalierly dismisses this important distinction and argues that the Ninth Circuit's decision in *Burgess v. Premier Corp.*, 727 F.2d 826 (9th Cir. 1984) conflicts with the Second Circuit's decision below in *Salcer* and the Eighth Circuit's *en banc* decision in *Loftsgaarden*. However, unlike *Salcer* and *Loftsgaarden*, *Burgess* dealt with the tax benefit issue in the context of a claim for actual rescission.

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[3] An "open year" is any tax year as to which the statute of limitations has not run and, therefore, is subject to audit by the IRS. Under Internal Revenue Code Section 6501, a tax year is generally considered "closed" three years after the return for that year has been filed. 26 U.S.C. §6501. Accordingly, it appears that the five years relating to the Greenspoint Project, 1977-1981, are now "closed."

[4] There might be taxes due on the damage award itself in the year in which it is received which may be treated for tax purposes in either of the following ways:

1) *Capital Gains.* If the assets had been previously sold, as in the case of Greenspoint, the investors could treat the damage award as additional "capital gains" from their investment pursuant to Section 741 of the Internal Revenue Code. 26 U.S.C. §741.

2) *Ordinary Income.* Under the "tax benefit" rule, a taxpayer may be required to treat as "ordinary income" any monies received with respect to the tax shelter which constitutes the return of amounts previously deducted against ordinary income. *See Hillsboro National Bank v. Commissioner*, 460 U.S. 370 (1983).

It is clear from the facts in *Burgess* that, contrary to the Government's contention (Gov. Br. 5n.3), rescission of the challenged investments was, indeed, still possible. As stated by the Ninth Circuit in *Burgess*:

> After losing money for several years on their investments, four of the [plaintiffs] sold their herds *back to Premier* [the promoter], and one disposed of his herd on the open market. * * * [¶] In 1978 the five [plaintiffs] filed this action against Premier.

727 F.2d at 830 (emphasis added). It is thus plain that the Second and Eighth Circuits correctly distinguished *Burgess*, since four of the five plaintiffs there sought actual rescission. Having already partially undone the original transaction by selling the herds back to Premier (the promoter), those four plaintiffs then sued Premier to undo the transaction completely, *i.e.*, to recover the remainder of their investment. Upon conclusion of the litigation, those plaintiffs would indeed have achieved actual rescission: Premier would have its herds once again, and the plaintiffs would have all their money.

In any event, whatever the appropriate damage theory for that lawsuit, the Ninth Circuit manifestly *believed* it was deciding a case of actual rescission, as indicated by the following three quotations from the *Burgess* opinion (emphasis added):

> "*Rescission* was an appropriate remedy for the [plaintiffs'] claims." 727 F.2d at 837.

> "*Rescission* voids the transaction and returns to both parties the consideration they paid." *Id.*

> "*Rescission* is accomplished by returning to [plaintiffs] the $496,128 which the jury found and Premier et al. concede to be the out of pocket loss." *Id.*

It is further apparent from the *reasoning* of the Ninth Circuit's decision that the *Burgess* court believed it was deciding a case of actual rescission. The court twice stated that a judgment

in plaintiffs' favor would require them to file amended returns for prior years, thus, presumably, undoing all of the deductions taken in those years. *Id.* at 838. As shown above, as a matter of tax law, in cases such as *Salcer* and *Loftsgaarden*, involving claims for rescissionary damages, there would be no need to go back to amend prior years' returns for recomputation or elimination of the tax benefits received in those years.

The *Burgess* decision, therefore, is not in conflict with either *Salcer* or *Loftsgaarden*. There being no conflict among the circuits, the petition for a writ of *certiorari* should be denied.

POINT III

THIS ISSUE IS PREMATURE FOR REVIEW

The precise issue here has been decided by only the Second and Eighth Circuits, and both decisions involved real estate tax shelter investments.[5] This is significant because the Government relies on the argument that the investors' tax benefits were illusory (Gov. Br. 7-11) and the permanence of these tax benefits may well depend upon the specific sections of the Internal Revenue Code that are involved. The multifarious varieties of tax shelter investments in the marketplace – cattle deals, publishing and movie deals, franchise deals, oil and gas deals, and coal deals, to name but a few – involve different sections of the Code from real estate deals, and the issue of reducing rescissionary damage awards by the amount of the net tax benefits received has not been considered by the circuit courts in any of those contexts. This Court, therefore, should decline review until further consideration has been given the issue by other circuits and in other factual and legal contexts.

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[5] As shown above in Point II, *Burgess*, which involved a cattle tax shelter, did not decide the precise issue in this case. In *Freschi v. Grand Coal Venture*, 767 F.2d 1041 (2d Cir. 1985), *pet. for cert. pending*, No. 85-377, which involved a coal lease tax shelter, the court was considering tax deductions taken by the investors which did not arise out of the operation of the tax shelter, as they did here and in *Loftsgaarden*.

As three Members of this Court have noted in explaining their vote to deny *certiorari* in another case:

> I believe that further consideration of the substantive and procedural ramifications of the problem by other courts will enable us to deal with the issue more wisely at a later date.

McCray v. New York, 461 U.S. 961, 962 (1983) (opinion of Stevens, J., joined by Blackmun and Powell, JJ., respecting the denial of *certiorari*). Moreover, it is "a sound exercise of discretion" to allow the various circuits to "serve as laboratories in which the issue receives further study before it is addressed by this Court." *Id.* at 963.

The benefits of withholding review at this stage are significant. Should other circuits concur in the result reached by the Second and Eighth Circuits, the law will remain uniform, and this Court will be able to devote its scarce judicial resources to issues that truly require resolution by the Court. On the other hand, should other circuits disagree with the conclusion of Second and Eighth Circuits, this Court will have the benefit of additional judicial consideration and analysis of the issue when it accepts review.

Accordingly, contrary to the Government's view (Gov. Br. 12-13), the petitions for writs of *certiorari* should be denied in both *Salcer* and *Loftsgaarden*.

POINT IV

IF REVIEW IS GRANTED IN LOFTSGAARDEN OR FRESCHI, REVIEW SHOULD BE GRANTED HEREIN

Notwithstanding Points I-III, if this Court accepts the Government's request and grants review in *Loftsgaarden* or *Freschi v. Grand Coal Venture*, No. 85-377,[6] it should also grant review in *Salcer* because *Salcer* presents one of the strongest possible fact situations in favor of reducing a rescissionary damage award in tax shelter litigation by the amount of the tax benefits received by the investors.

As the Second Circuit acknowledged, there is no dispute among the parties in *Salcer* that the tax benefits claimed by petitioners were legal and in the correct amount. (App. 4a-5a) Moreover, none of these benefits are still subject to "recapture," since recapture would already have occurred upon sale of the project in 1981.[7]

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[6] In *Freschi*, the Second Circuit held that an award of damages had to be reduced by the amount of the tax deduction claimed. Those tax deductions did not arise out of the operation of the tax shelter, but rather were ordinary business deductions claimed as a result of the *loss of the investment*. Inasmuch as the fact situation in *Freschi* is completely different from that in *Salcer*, which solely involves bargained-for tax benefits arising directly out of a tax shelter project, respondents herein take no position on the merits in *Freschi*.

[7] In rejecting arguments made by the SEC and the Tax Division that plaintiffs' tax benefits might not be permanent and thus should be ignored, the Second Circuit stated (App. 15a-16a):

> Despite the fact that plaintiffs took the deductions during the period from 1977-81, thereby giving the I.R.S. several years to challenge them, it has not sought to disallow them. Indeed, the government merely speculates that it "*may*" challenge them some time in the future and that it is possible that they "*could* be denied in whole *or in part*" (emphasis added). Brief at 5. * * * If the I.R.S.'s position is that the plaintiffs are not entitled to the tax benefits they took, its duty is to disallow the deductions rather than attempt to place the issue in limbo indefinitely. Despite ample time for an audit and initial decision it has failed to act.

(App. 16a) Finally, petitioners agree that they already have received a substantial net gain in the transaction, even without taking into account their prospective recovery in this action. They have invested $77,500 per unit and have already received $30,000 per unit from the sale of the project and $67,866 per unit in net permanent tax benefits, for a total of $97,866 per unit. (App. 4a-5a, 14a) Any additional recovery received by way of damages would only result in a *further* net benefit to petitioners, whether or not such recovery is taxable.

Should this Court choose to review the tax benefit damage issue in either *Loftsgaarden* or *Freschi*, it should have before it the facts presented in the *Salcer* case, as well.

CONCLUSION

The petition for a writ of *certiorari* should be denied, notwithstanding the Government's arguments. If, however, *certiorari* is granted in *Loftsgaarden* or *Freschi*, *certiorari* should also be granted here.

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